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IN THE

Supreme Court of the United States

OCTOBER TERM, A. D. 1941.

No. 283

BUTLER BROTHERS, A CORPORATION,
Appellant,

vs.

CHARLES J. McCOLGAN, AS FRANCHISE TAX COMMISSIONER OF THE STATE OF CALIFORNIA,
Appellee.

ON APPEAL FROM THE SUPREME COURT OF THE STATE OF CALIFORNIA.

APPELLANT'S BRIEF.

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CHARLES J. McCOLGAN, AS FRANCHISE TAX COMMISSIONER OF THE STATE OF CALIFORNIA,

Appellee.

ON APPEAL FROM THE SUPREME COURT OF THE STATE OF CALIFORNIA.

APPELLANT'S BRIEF.

MAY IT PLEASE THE COURT:

OPINIONS BELOW.

The opinion of the California Supreme Court is reported in 17 Cal. (2), 664, 111 Pac. (2d) 334. It appears in the record beginning at page 24.

The opinion of the California District Court of Appeals is reported in 101 C. A. D. (Calif. App. Dec.) 612, 102 Pac. (2d) 776. It appears in the record beginning at page 16.

There was no opinion in the trial court. The judgment of that court appears in the record at pages 12-13.

JURISDICTION.

The judgment of the court below was entered on March 21, 1941. (R. p. 38.) The petition for rehearing was denied on April 17, 1941. (R. p. 41.)

Application for appeal was made and granted on June 28, 1941.

The transcript of the record was filed in this Court on July 19, 1941. Probable jurisdiction was noted on October 13, 1941.

The jurisdiction of this Court is invoked under section 237 (a) of the Judicial Code as amended. 28 U. S. C. A., section 344 (a). There is here drawn in question the validity of a statute of the State of California on the ground of its being repugnant to the Constitution of the United States. The decision of the California Supreme Court, which is the highest court of the State of California in which a decision in this suit could be had, was in favor of its validity.

Appeal now lies in lieu of a writ of error. Act of January 31, 1928, Chapt. 14, 45 Stat. 54, as amended by Act of April 26, 1928, Chapt. 440, Stat. 466. The case is one in which under legislation in force when the above Act of January 31, 1928 was passed, review could be had in this Court on writ of error.

Where the question is as to the validity of a statutory method of apportionment of net income and as to the validity of the statute so authorizing or requiring such method of apportionment, the review is by way of appeal from the judgment of the state court.

Underwood Typewriter Co. v. *Chamberlain*, 254 U. S. 113.

Bass, Ratcliff & Gretton v. *State Tax Commissioner*, 266 U. S. 271.

Hans Rees' Sons, Incorporated v. *North Carolina*, 283 U. S. 123.

Norfolk & Western Ry. Co. v. *Maxwell*, 297 U. S. 682.

North American Cement Corporation v. *Graves*, 299 U. S. 517.

STATEMENT.

This suit was brought by Appellant in the Superior Court of the State of California in and for the City and County of San Francisco, against the State Treasurer of the State of California to recover a franchise tax amounting to $3,798.43, together with interest thereon amounting to $344.67. The tax was assessed under the provisions of the Bank and Corporation Franchise Tax Act of California. (Statutes 1929, p. 19, as amended.) Section 4, subdivision 3, and section 10 of said Act as in force at all times material to this case are set forth in the margin.[1] Payment of the tax and interest was made under protest.

The tax here in question was assessed with respect to the year 1936, but under the statute was determinable in accordance with Appellant's net income in California for the year 1935.

---

1. "4. *Financial corporation to pay tax.* • • •

(3) *Corporations other than financial doing business in this State to pay tax. Minimum tax.* With the exception of financial corporations, every corporation doing business within the limits of this State and not expressly exempted from taxation by the provisions of the Constitution of this State or by this act, shall annually pay to the State, for the privilege of exercising its corporate franchises within this State, a tax according to or measured by its net income, to be computed, in the manner hereinafter provided, at the rate of four per centum upon the basis of its net income for the next preceding fiscal or calendar year. In any event, each such corporation shall pay annually to the State, for the said privilege, a minimum tax of twenty-five dollars.

• • • • •

"10. *Computation of tax on intrastate business.* If the entire business of the bank or corporation is done within this State, the tax shall be according to or measured by its entire net income; and if the entire business of such bank or corporation is not done within this State, the tax shall be according to or measured by that portion thereof which is derived from business done within this State. The portion of net income derived from business done within this State, shall be determined by an allocation upon the basis of sales, purchases, expenses of manufacturer, pay roll, value and situs of tangible property, or by reference to these or other factors, or by such other method of allocation as is fairly calculated to assign to the State the portion of net income reasonably attributable to the business done within this State and to avoid subjecting the taxpayer to double taxation.

"If the commissioner reallocates net income upon his examination of any return, he shall, upon the written request of the taxpayer, disclose to him the basis upon which his reallocation has been made."

Appellant filed its return for the year 1936, from which return it appeared that Appellant had a loss of $82,851 for the year 1935. Accordingly, Appellant paid the minimum tax of $25 upon the filing of its return.

On January 25, 1937 the Franchise Tax Commissioner notified Appellant of the proposed additional assessment of $3,798.43—which is the tax here involved. Thereupon Appellant protested such assessment. (R. p. 3.) The protest asserted the invalidity of the assessment under the rule of *Hans Rees' Sons, Incorporated* v. *North Carolina*, 283 U. S. 123. (R. p. 4.) On August 5, 1937, Appellant was advised that the additional assessment had been confirmed, and on September 8th the additional tax was assessed with interest from March 15, 1936. On September 16, 1937 the additional assessment, together with the interest thereon amounting to $344.67, was paid—under protest. (R. p. 4.) Among other things it was stated in the protest that the tax

> "is a tax upon business and transactions conducted without the State of California, is without the power of jurisdiction of the State of California, will deprive Butler Brothers of property without due process of law, will deprive Butler Brothers of the equal protection of the law, and is in violation of its rights under the Constitution of the United States and the Constitution of the State of California.
>
> "The Bank and Corporation Franchise Tax Act, if construed as authorizing the assessment of the taxes here protested, is in violation of the Constitution of the United States and of the Constitution of the State of California."

On October 18, 1937, this suit was filed. (R. p. 1.) The complaint asserted the invalidity of the entire assessment. (R. p. 2.) Copies of the two protests were attached to the complaint as exhibits A and B thereto. (R. pp. 3, 4.)

In his answer to the complaint the State Treasurer denied the allegations of the complaint as to the invalidity

of the assessment, and further denied the allegations contained in said Exhibit B to the complaint. (R. p. 7.)

The case was tried upon a stipulation of facts.

Paragraphs 10 and 11 of the Stipulation provided as follows (R. p. 11):

> "10. It is claimed by defendant that by reason of the facts hereinabove set forth the operations of the Company are unitary in character and that the formula for allocation of income used by the Franchise Commissioner was lawful and proper and that the Company is not entitled, for the purpose of determining tax payable under the Bank and Corporation Franchise Tax Act, to use separate accounting of its San Francisco house to determine its net income in the State of California."
>
> "11. It is claimed by the Company that its operations are not unitary in character; that its net income reasonably attributable to the business done within the State of California is the income derived from its San Francisco house alone which resulted in a loss in the year 1935; that the method of allocation used by the Commissioner is not in accordance with the provisions of the Bank and Corporation Franchise Tax Act, and that if said Act is construed as authorizing such method of allocation and assessment, said Act is in violation of the due process clause of the Fourteenth Amendment to the Constitution of the United States."

The trial court sustained the validity of the tax and entered judgment against Appellant, adopting in that connection the stipulation of facts as its own findings of fact, and simply holding that the additional assessment was "duly and regularly made" pursuant to the statute. (R. p. 13.)

Appellant thereupon appealed to the Supreme Court of the State of California. Subsequently Charles J. McColgan as Franchise Tax Commissioner of the State of California, Appellee herein, was substituted in place of

Charles G. Johnson as Treasurer, who was the original defendant. (R. pp. 15-16.)

Thereafter the California Supreme Court transferred the case to the District Court of Appeal for the Third Appellate District for hearing. That Court held the assessment void, and accordingly reversed the judgment of the trial court with directions to the trial court to enter judgment for Appellant. (R. p. 24.)

Thereupon, upon defendant's petition, the California Supreme Court directed that the case be retransferred to it for hearing.

Upon hearing in that court the assessment was held valid. The California Supreme Court held that Appellant's business was "unitary" in character and that the use of an allocation formula was made mandatory by the statute. The statute as thus construed and applied was also held valid and in no way repugnant to the Federal Constitution. The judgment of the trial court was accordingly affirmed. (R. p. 38.)

Appellant's petition for rehearing was, as stated, denied on April 17, 1941. (R. p. 41.) This appeal followed.

The Facts.

As stated, the case was tried upon a stipulation of facts, which stipulation was adopted by the trial court as its findings of fact. (R. p. 13.) The facts so stipulated are not lengthy, and are as follows (R. pp. 8-13):

> "1. Butler Brothers, plaintiff herein (hereinafter called the Company), is a corporation organized under the laws of Illinois and is qualified to conduct business in California. Its corporate principal place of business is in Chicago, Illinois. The Company is engaged in the wholesale dry goods and general merchandise business, purchasing from manufacturers and others, and selling such commodities to retailers only.

It maintains and operates wholesale distributing houses at Chicago, Illinois, Minneapolis, Minnesota, St. Louis, Missouri, Jersey City, New Jersey, Baltimore, Maryland, Dallas, Texas, and San Francisco, California. The San Francisco house was opened by the Company in 1928, being the last established of all the Company's houses, except that the one at Baltimore was acquired as a going concern in 1930.

"2. Stocks of goods are maintained at each of the Company's houses hereinabove mentioned, from which sales in the respective territories served by each house are made. Each house serves a separate trade territory, having its own sales force, and all sales made by the Company in the State of California are made from the San Francisco house. Each house handles its own sales and all solicitation, credit and collection arrangements in connection therewith. Books of account are kept at each house, wherein are entered the sales made thereat, the amounts paid for goods sold therefrom, transportation charges and other operating expenses, including the allocation of certain common expenses referred to in paragraph 4 hereof. It is agreed that all receipts from sales made in California have been credited to the San Francisco house.

"3. The Company maintains a central buying division through which goods for resale are ordered, but such goods are shipped by the manufacturers to the houses for which ordered, where the cost thereof and transportation charges thereon are entered on the books of the house. No charges are made against any house for the benefit of the Company or any other house by reason of such centralized purchasing, but the actual cost of operating the centralized buying division is allocated to the houses, as stated in paragraph 4 hereof. The greater part of other operating expenses incurred by the Company are directly and exclusively incurred at the respective houses, including such items as labor, rentals and similar expenses.

"4. There are certain items of expense which are incurred and paid by the Company for the benefit of all houses, the costs of which are allocated to the re-

spective houses. No question exists as to the accuracy of the amounts of such expense or to the method of allocation employed, which is in accordance with recognized accounting practices. For the year 1935 the amount of such allocated expense charged to the San Francisco house was $100,091. For the purposes of this case, and without prejudice to the claims of either party in any subsequent year, it is agreed that approximately 75% of the $100,091 overhead expense so allocated would have been incurred even though the San Francisco house was not operated, and that the accuracy and propriety of the basis of allocation of such common expenses for the year 1935 are admitted. Included in such expenses are executive salaries, certain accounting expenses, the cost of operating a central buying division, and a central advertising division. Except for such common expenses, each house is operated independently of each other house.

"5. The Company computed its income from the operation of the San Francisco house by deducting from the gross receipts from sales of merchandise in California, determined as indicated in paragraph 2 above, the costs of such merchandise, determined as indicated in paragraph 3 above, the direct expenses of the San Francisco house referred to in paragraph 3; and the indirect expense allocated to the San Francisco house in the manner described in paragraph 4 above. According to this computation, the San Francisco house operated at a loss of $82,851 during the year 1935.

"6. The Company filed with the Franchise Tax Commissioner a report in the prescribed form, wherein it was reported that the San Francisco house was operated at said loss, and, within the time provided by law, paid the minimum tax of $25 for the year 1936. An additional assessment was made by the Franchise Tax Commissioner and paid by the Company as alleged in the complaint.

"7. In the year 1935 the operations of all houses of the Company produced a profit of $1,149,677. The

additional tax assessed by the Franchise Tax Commissioner was predicated on the allocation to California of 8.1372% of the total income of the Company derived from all sources, such percentage having been determined by mathematical average of the percentages which (a) value of real and tangible personal property, (b) wages, salaries, commissions and other compensation of employees, and (c) gross sales, less returns and allowances, attributable to the San Francisco house bore to the corresponding items of all houses of the Company. It is also agreed that the Franchise Tax Commissioner, in imposing the additional assessment upon the Company, did not give consideration to any other factor or method of allocation. No question exists as to the accuracy of the Commission's calculation, nor respecting the use of the above formulas, if, by reason of the facts stipulated herein, a formula for allocation to California of a portion of the Company's income from all sources is proper. This stipulation is made without prejudice as to any other year than that on which the tax here involved is predicated.

"8. In the year 1935 the total sales made by the Company at all houses amounted to $66,326,000, of which $5,206,000 were made from the San Francisco house. The purchases made for the account of the San Francisco house were substantially in the same proportion to total purchases. All purchases made by the Company for sale at its various houses are made through a central buying division. By reason of the volume of purchases made by the Company more favorable prices are obtained than would be obtainable in respect of purchases for the account of any individual house operated by the Company.

"9. The addition of purchases in an amount equal to the purchases made for the account of the San Francisco house results in no more favorable prices than could be obtainable in respect of purchases in an amount equal to the purchases which would be made by the Company for its other houses if the San Francisco house were not in existence, and a reduction

in the volume of purchases in an amount equal to the purchases made for the San Francisco house would result in no less favorable prices being obtainable in respect of the purchases which would be made for the remaining houses of the Company. The stipulation in this paragraph shall not be deemed an admission by defendant that plaintiff is entitled to segregate the income of its San Francisco house from that of other houses for purposes of computing franchise tax."

The provisions of Paragraphs 10 and 11 of the Stipulation have been heretofore stated. *Supra*, p. 5.

Paragraph 13 of the Stipulation (R. p. 12) provided as follows:

"13. The stipulations of fact herein contained are without prejudice to the claim of plaintiff that its earnings in California are solely those derived from operation of its San Francisco house, and that it is taxable in California only in respect of such earnings, without regard to earnings from its operations in other states and without prejudice to the claim of defendant that plaintiff's operations in California are of such character as to be incapable of segregation from its other operations, and that plaintiff may be taxed on an allocation of its entire net income in the manner done by the defendant."

Paragraph 12 of the Stipulation (R. p. 11) provided as follows:

"12. It is agreed that the foregoing facts, in addition to those alleged in the complaint and admitted by the answer, were submitted to and considered by the Franchise Tax Commissioner, and that the assessment of additional tax made by him was predicated entirely upon the theory that as a matter of law the business done by the Company as hereinbefore set forth is a part of a unitary business warranting the application of the method of allocation of the Company's total net income hereinabove described. It is agreed that no other fact or circumstance was con-

sidered or used by the Commissioner in making such assessment and that the Court, in determining this case, shall be bound by no inference or presumption in respect of any matter of fact not herein set forth, and if, despite this stipulation, the Court deems that it is bound by any inference or presumption respecting the assessment made by the Commissioner, or that this stipulation fails to establish any fact necessary to a decision, the case shall be re-opened for the taking of further proofs in respect thereof."

Points Relied On and Specification of Such of the Assigned Errors as Are Intended To Be Urged.

"That the Supreme Court of the State of California erred in rendering its said decision, affirming the judgment of the Superior Court of the State of California in and for the City and County of San Francisco, the court of first instance in said cause, in each of the respects hereinafter stated:

"1. In holding that the California Bank and Corporation Franchise Tax Act, California Statutes of 1929, page 19, as amended, did not deprive Petitioner of its property without due process of law, in violation of the Fourteenth Amendment to the Constitution of the United States.

"2. In holding that said Act did not impose a tax on income of Petitioner earned and derived from sources wholly outside of the State of California, thus depriving Petitioner of its property without due process of law, in violation of the Fourteenth Amendment to the Constitution of the United States.

"3. In holding that said Act did not deprive Petitioner of its property without due process of law, in violation of the Fourteenth Amendment to the Constitution of the United States, although said Act as construed by said Court levied a tax upon a percentage of Petitioner's net income allocated to the State of California by an arbitrary allocation formula (based upon a comparison of Petitioner's property, payroll and sales within California as compared to Petitioner's

total payroll, property and sales), in spite of the fact that Petitioner's operations in the State of California were conducted at a loss of $82,851 and Petitioner in fact earned no net income from its operations within the State of California and derived no net income from sources within the State of California.

"4. In holding that although in fact Petitioner's operations within the State of California resulted in a loss of $82,851, it was nevertheless subject to a tax on an assumed net income of more than $90,000 by application of the formula prescribed by said Bank and Corporation Franchise Tax Act as amended, and in holding that said Act in imposing such tax did not deprive appellant of its property without due process of law, in violation of the Fourteenth Amendment to the Constitution of the United States.

"5. In holding that Petitioner's business, although it consists only of buying and selling merchandise, is a 'unitary' business; in holding that in the case of a unitary business the Bank and Corporation Franchise Tax Act imposes a tax based on a formula allocation of income regardless of an actual loss incurred on business done in California, and in holding that said Act in so imposing such tax does not deprive appellant of its property without due process of law, in violation of the Fourteenth Amendment to the Constitution of the United States.

"6. In deciding this case by indulging in inferences and presumptions contrary to the provisions of paragraph 12 of the stipulation of facts upon which this case was tried." (Assignment of Errors, R. pp. 41-43; Statement of Points to be Relied Upon, R. pp. 46-48.)

SUMMARY OF ARGUMENT.

The Bank and Corporation Franchise Tax Act of California provides for a tax in the case of a foreign corporation "for the privilege of exercising its corporate franchises within this State according to or measured by its net income to be computed" etc., and (sec. 10) that if the entire business of the corporation is not done within California the tax shall be according to or measured by that portion thereof "which is derived from business done within" California, and finally that such income is to be determined either by an allocation based upon sales, purchases, expenses of manufacture, payroll, value and situs of the tangible property "or by reference to these or other factors, or by such other method of allocation as is fairly calculated to assign to the state the portion of net income reasonably attributable to the business done within this state and to avoid subjecting the taxpayer to double taxation." Appellant is engaged in the wholesale merchandise business and operates seven branch houses, one of them situate in San Francisco. Appellant purchases its merchandise from manufacturers throughout the United States, which merchandise is shipped from the various factories and mills directly to the respective branch houses. Each house sells throughout its own trade territory, out of stocks of merchandise maintained at such house. Each house has its own sales force and handles its own sales solicitation, credit, and collection arrangements. Books of account are kept at each house wherein are entered the sales made, the amounts paid, transportation charges, and other operating expenses including the allocation of certain common expenses. All receipts from sales made at San Francisco are credited to that house, including receipts from sales in other states comprised within the San Francisco house's

trade territory. Merchandise is purchased by a central buying division, although the merchandise itself is shipped from the various factories and mills where produced directly to the various houses. Appellant's sales are made to retailers for purposes of resale. Each house is charged only with the actual cost of the merchandise which it sells plus transportation charges from the factory or mill to such house. No charge is made against any house for the benefit of the company or any other house by reason of such centralized purchasing. The greater part of other operating expenses incurred by the company are directly and exclusively incurred at the respecting houses, including such items as labor, rental, and the like.

There are certain items of expense which are incurred and paid by the company for the benefit of all houses, the costs of which are allocated to the respective houses. The parties have agreed that no question exists as to the accuracy of the amounts of such expense or to the method of allocation employed which is in accordance with recognized accounting practices. In 1935 the amount of such allocated expenses to the San Francisco house was $100,091. For the purposes of this case, it is agreed that approximately 75 per cent of that amount would have been incurred even though the San Francisco house was not operating. Included in these common expenses are "executive salaries, certain accounting expenses, the cost of operating a central buying division, and a central advertising division." (Stip. Par. 4, R. p. 9.) It is expressly agreed by the parties that "except for such common expenses, each house is operated independently of each other house." (Stip. Par. 4, R. p. 9.)

Appellant computed its income from the operations of the San Francisco house by deducting from the gross receipts of sales of merchandise made at that house, first, the cost of such merchandise, second, the direct expenses of the San Francisco house above referred to, and, third, the al-

located expense. According to this computation the San Francisco house operated at a loss of $82,851 during the year 1935. Appellant filed its return for the calendar year 1936 and (its operations for the preceding year, which determined the amount of the tax for the ensuing year, showing a loss) paid the minimum tax of $25.00.

In 1935 the operations of Appellant's houses as a whole produced a profit of $1,149,677 after taking into consideration the loss at San Francisco of $82,851. Appellee assessed an additional franchise tax based upon an allocation of a percentage of Appellant's above total net income, such percentage—8.1372 per cent—being determined by averaging the percentages of the (1) value of real and tangible personal property in the state, (2) wages, salaries, commissions and other compensation of employes, and (3) gross sales attributable to the San Francisco house as compared to the corresponding items of all Appellant's houses. The parties further agreed that in assessing the additional tax Appellee gave no consideration to any other factor or method of allocation, and that for the purposes of this case no question exists as to the accuracy of Appellee's calculation, nor respecting the use of said formula if, under the facts of the case as stipulated, an allocation formula applied to Appellant's total net income is proper. (R. p. 10.)

Appellant's total sales for 1935 were $66,326,000. The sales of the San Francisco house were $5,206,000. The purchases of merchandise made for the San Francisco house were substantially in the same proportion of total purchases as the San Francisco sales were to the total sales. It was further agreed that by reason of the volume of purchases made by Appellant more favorable prices were obtained than would be obtainable with respect to purchases for the account of *any individual house* operated by Appellant.

The parties further agreed that the "addition of pur-

chases in an amount equal to the purchases made for the account of the San Francisco house results in no more favorable prices than could be obtainable in respect of purchases in an amount equal to the purchases which would be made by Appellant for its other houses if the San Francisco house were not in existence, and a reduction in the volume of purchases in an amount equal to the purchases made for the San Francisco house would result in no less favorable prices being obtainable in respect of the purchases which would be made for the remaining houses of the company." (Stip. of Facts, Par. 9; R. p. 10.)

The parties further stipulated that the assessment here involved "was predicated entirely upon the theory that as a matter of law the business done by the company as hereinbefore set forth is a part of a unitary business warranting the application of the method of allocation of the company's total net income hereinabove described." (Stip. of Facts, Par. 12; R. p. 11.) Said paragraph 12 of the stipulation further provides that it "is agreed that no other fact or circumstance was considered or used by the Commissioner in making such assessment and that the Court, in determining this case, shall be bound by no inference or presumption in respect of any matter of fact not herein set forth, and if, despite this stipulation, the Court deems that it is bound by any inference or presumption respecting the assessment made by the Commissioner, or that this stipulation fails to establish any fact necessary to a decision, the case shall be reopened for the taking of further proofs in respect thereof."

I.

THE TAX HERE INVOLVED IS VOID. THE CALIFORNIA STATUTE AS CONSTRUED AND APPLIED BY THE CALIFORNIA SUPREME COURT IS LIKEWISE VOID. THE CASE OF HANS REES' SONS, INCORPORATED v. NORTH CAROLINA, 283 U. S. 123 IS CONTROLLING.

Asserting reliance upon *Underwood Typewriter Co.* v. *Chamberlain*, 254 U. S. 113; *Bass, Ratcliff & Gretton* v. *State Tax Commission*, 266 U. S. 271, and *North American Cement Corporation* v. *Graves*, 299 U. S. 123, the court below considered Appellant's business to be "unitary," held the statutory formula method of allocating income to California to be mandatory and the statute and the consequent tax to be valid.

The court further considered that the decision of this court in *Hans Rees' Sons, Incorporated* v. *North Carolina*, 283 U. S. 123, did not control. Apparently the court below thought that because the merchandise sold by the San Francisco house was centrally purchased along with the merchandise sold by Appellant's other houses, the San Francisco house operations were so integral a part of Appellant's business as a whole that the income of that house—the income from Appellant's California business—could not be segregated or separately determined.

The court below argued that because, according to the stipulated facts, Appellant was able to buy at lower prices because of its volume of purchases—something which we would think would be more or less self evident—Appellant's San Francisco house and business were therefore completely interdependent upon Appellant's other houses and upon its business as a whole. Having thus viewed the operations of the San Francisco house and Appellant's business as a whole, the court below thought Appellant's business to be "unitary."

In the above connection the court below has put aside

the explicit stipulation of the parties, that the addition or subtraction of purchases equal to the amount purchased for the account of the San Francisco house would have absolutely no effect upon Appellant's aggregate purchasing power. (Stipulation of Facts, Par. 9, R. p. 10.) There was no such stipulation in that regard with respect to any of Appellant's other houses. And the court below thus challenges the correctness of the facts which the parties to this suit have themselves agreed upon for the express purposes of this suit.

The court below also stated that Appellant's San Francisco house should be "credited with the profits resulting from the purchasing power which such sales in the aggregate produce." (R. p. 29.) In making this statement the court loses sight of the fact that the San Francisco house was in fact credited with its full proportionate share of the profits resulting from Appellant's aggregate purchasing power when that house was charged only with the actual cost of the merchandise which it sold. We see no other conceivable way in which the San Francisco house could be given the full credit of its proportionate share of the profit resulting from Appellant's aggregate purchasing power. Only if it appeared that the San Francisco house was charged with more than the cost of the merchandise—like the Wisconsin business involved in *Standard Oil Co. v. Wisconsin*, 197 Wis. 630, 223 N. W. 85—would the view of the court below have any semblance of merit.

Contrary to what seems to be the view of the court below and of Appellee, the *Rees* case is not to be considered as overruled by *North American Cement Corporation v. Graves*, 299 U. S. 317. The last named case was simply a decision of the same kind as in the *Underwood Typewriter* case and in the *Bass* case, it being held (in the *North American Cement* case) that the New York statute is "valid upon its face and it has not been shown to have been so ap-

plied as to violate" the corporation's constitutional rights —citing the *Bass* case.

The principle of the *Rees* case is a principle of long standing. Such principle had been repeatedly applied by this court in earlier decisions where taxes based upon statutory formulae were invalid because of the factual showing made that the application of the formula produced unreasonable and arbitrary results.

There is no real relevancy between the factors entering into the statutory percentage formula applicable to the San Francisco house and the same factors as applied to Appellant's business as a whole. It is difficult, if not impossible, to conceive how, in view of the manner in which Appellant's several houses are operated, the Appellant's merchandise or other property, including real estate, owned by the company in other states or the amount of its payroll, etc., in other states, or even its gross sales in other states, have or could have any direct bearing upon the results of the operation of the San Francisco house. All of that property; and all of such wages and salaries, and such sales, could be more or less in amount in dollars in other states without materially affecting the results of the San Francisco house whatsoever.

II.

THE FACT THAT A BUSINESS IS "UNITARY" IS NOT CONTROLLING IN DETERMINING THE LEGALITY OF A STATUTORY FORMULA METHOD OF APPORTIONMENT.

Even if Appellant's business were unitary the tax is still void. This was expressly held in *Hans Rees' Sons, Incorporated* v. *North Carolina*, 283 U. S. 123, where this Court assumed the business of the company there involved to be unitary (a manufacturing business), but still held the formula method of allocation and the resulting tax invalid

on the ground that the evidence showed that the result of the application of the statutory formula was unreasonable and arbitrary. In that connection the evidence tended to show that only 17 per cent of the company's business was properly attributable to North Carolina, whereas the statutory formula attributed about 80 per cent to that state. In the instant case, according to the actual figures, Appellant incurred a loss of $82,851 in California. The application of the statutory allocation formula resulted in attributing to California income amounting to $93,551.50—thereby converting a loss *in fact* of $82,851 into an alleged profit of $93,551.50, a difference of $175,000. To attribute $175,000 of additional income to California in order to produce a tax means either that that much income has been appropriated from other states—thereby subjecting Appellant to double taxation with respect to such income—or else it means that Appellant's total net income is $175,000 more in the aggregate than what the parties have agreed it to be. In either view the operation and application of the statutory allocation formula is unreasonable, arbitrary and confiscatory. And the resulting tax is invalid within the principle of the *Rees* case.

The California court's conception of the rule is clearly erroneous when it says (R. p. 27) that only where the business within the taxing state is truly separate and distinct from its business without the state so that segregation of income may be made clearly and accurately, that the separate accounting method may properly be used. We submit that the term "separate accounting" is of no special significance. The rule of this court is that if the allocation formula results unreasonably or arbitrarily it will not be sustained even where the company's business is unitary. This rule applies even in the case of interstate carriers where it would be a rare occasion, if it ever occurred, where the rail mileage within the taxing state is "truly separate and distinct" from its mileage without the state.

The rule, concisely stated, is that if the income from the business within the state can be reasonably and accurately determined upon its own footing, and if it then appears that the application of the statutory formula attributes income to the taxing state grossly disproportionate to the income separately determined, the formula will not be sustained, and any tax resulting from the application of the formula will be invalid. Indeed the rule is even broader. Where the income within the taxing state is capable of separate determination with reasonable accuracy, there is no room for any apportionment formula.

III.

THE FACT THAT THE TAX IS AN EXCISE TAX IS IMMATERIAL.

This court, in the *Underwood Typewriter* case, said that in considering the question as to the validity of the tax all question is laid aside as to whether the tax is an excise, purporting to be measured by income, or is a direct tax upon that income, and that the decision in any particular case will not be made to depend upon mere definitions. Appellees contention in this regard necessarily assumes that the *Rees* case involved an income tax and not an excise tax. Such is not the case, as the statute imposing the tax in the *Rees* case was characterized by the North Carolina court as substantially identical with the Connecticut statute involved in the *Underwood Typewriter* case, which statute in turn was held by the Connecticut court to lay an excise tax upon the privilege of doing, or the doing of, business in Connecticut. The California statute also lays an excise tax with the result that the *Rees* case is wholly in point.

IV.

APPELLANT'S BUSINESS IS NOT A UNITARY BUSINESS.

Whatever may be said of manufacturing businesses like that in the *Underwood* and *Bass* cases, Appellant's business is not a unitary business. It operates a collection of seven wholesale branch houses, each of which is conducted to all intents and purposes as a separate establishment. The fact of common ownership necessitates some allocation of overhead and other common expense. But this fact does not of itself make the business a unitary business. For a consideration of what constitutes a unitary business see *Maxwell v. Kent-Coffey Mfg. Co.*, 168 S. E. 397; *State* v. *Lion Oil Refining Co.*, 284 S. W. 33; *Utah-Idaho Sugar Co.* v. *Salt Lake County*, 210 Pac. 106; *Standard Oil Co.* v. *Wisconsin Tax Commission*, 197 Wis. 630, 223 N. W. 85; *Standard Oil Co.* v. *Thoresen*, C. C. A. 8, 29 Fed. (2d) 708; *Fisher* v. *Standard Oil Co.*, C. C. A. 8, 12 Fed. (2d) 444; *Standard Oil Co.* v. *Howe*, 257 Fed. 481; *J. G. McCrory Co.* v. *Commissioner*, 280 Mass. 273, 182 N. E. 481; *Mexican Petroleum Corporation of Georgia* v. *Head*, 13 S. E. (2d) 887. These cases all understood the principle of the *Rees* case (distinguishing in that connection cases like the *Underwood Typewriter* and *Bass* cases). Where the business within the taxing state is capable of reasonable segregation and separation in determining income there is no proper basis for applying a statutory formula.

V.

APPELLANT HAS NOT ACCEPTED AN ALLOCATION FORMULA IN PART AND ATTACKED IT IN PART.

This contention of Appellee is based upon *Norfolk & Western Ry. Co.* v. *Maxwell*, 297 U. S. 682. That case presents nothing of the situation involved in the instant case. There the carrier was attempting to allocate to North

Carolina income upon a formula allocation of its gross income, but to determine its North Carolina expenses by assigning specific expenses to the operation of the lines in that state. The state had offered evidence showing that the application of the formula resulted in a larger underestimate of revenue than a possible underestimate of expenses. The record as a whole left it uncertain as to whether the application of the formula to both revenue and expenses injured the company. There is no such situation presented in the case at bar.

ARGUMENT.

I.

THE TAX HERE INVOLVED IS VOID. THE CALIFORNIA STATUTE AS CONSTRUED AND APPLIED BY THE CALIFORNIA SUPREME COURT, IS LIKEWISE VOID. THE CASE OF HANS REES' SONS, INCORPORATED v. NORTH CAROLINA, 283 U. S. 123, IS CONTROLLING.

The tax here involved was assessed under the Bank and Corporation Franchise Tax Act of California (Statutes 1929, p. 19, as amended). Section 4, subdivision 3 of the Act (see *supra*, p. 3) requires payment of a tax "for the privilege of exercising its corporate franchises within this state according to or measured by its net income to be computed," etc.

Section 10 of the Act (see *supra*, p. 3) provides that if the entire business of the corporation is not done within California "the tax shall be according to or measured by that portion thereof which is derived from business done within" California.

Section 10 does not provide that the "business done within this state" *must* be determined by an allocation based upon sales, purchases, etc., but that the "business done" shall be determined *either* by such an allocation or

> "by such other method of allocation as is fairly calculated to assign to the state the portion of net income reasonably attributable to the business done within this state and to avoid subjecting the taxpayer to double taxation."

Said section 4, subdivision 3, and said section 10, together with other pertinent provisions of the Act, are set forth in the appendix hereto.

We would suppose that the clear intent of section 10 is to tax only that income which is derived from business done within the State of California, and that if that net income is clearly ascertainable by some method other than by mere formula allocation—which is more or less arbitrary at best—such method would be accepted as determinative of such net income. The court below in its opinion in this case seems to have thought otherwise inasmuch as it now holds that if the taxpayer's business is "unitary" the formula method of allocation is mandatory even though the taxpayer's actual net income from business done in California is otherwise clearly and reasonably determinable, and even though one result of the formula method of allocation is to subject the taxpayer to tax upon the same income both in California and elsewhere.

We submit that the decision below cannot be sustained consistently with the decision of this Court in *Hans Rees' Sons, Incorporated* v. *North Carolina*, 283 U. S. 123. In that case it appeared that the corporation there involved operated a manufacturing establishment in North Carolina. It bought hides, manufactured them into merchandise at its said factory, and sold the manufactured merchandise in numerous other states. The North Carolina statute imposed a tax upon the net income of the company in accordance with a formula based upon the valuation of the real estate and tangible property of the taxpayer within the State as compared to the valuation of the taxpayer's total real estate and tangible property in all states. This formula resulted in attributing to North Carolina approximately 80 per cent of the company's total net income.

Evidence was offered by taxpayer in the trial court which was summarized by the state court as tending to show that for the years 1923 to 1926, both inclusive, the average income of the company having its source in the

manufacturing and tanning operations of the company was 17 per cent. The question was as to whether the tax so resulting from the statutory formula method of apportionment was valid. The state court, relying upon *Underwood Typewriter Co.* v. *Chamberlain*, 254 U. S. 113, and *Bass, Ratcliff & Gretton* v. *State Tax Commissioner*, 266 U. S. 271, held the evidence immaterial and sustained the tax. This Court reversed, saying (283 U. S., at p. 132):

> "Evidence which was found to be lacking in the *Underwood* and *Bass* cases is present here. These decisions are not authority for the conclusion that where a corporation manufactures in one State and sells in another, the net profits of the entire transaction, as a unitary enterprise, may be attributed, regardless of evidence, to either State. • • •
>
> "Undoubtedly, the enterprise of a corporation which manufactures and sells its manufactured product is ordinarily a unitary business, and all the factors in that enterprise are essential to the realization of profits. The difficulty of making an exact apportionment is apparent and hence, when the State has adopted a method not intrinsically arbitrary, it will be sustained until proof is offered of an unreasonable and arbitrary application in particular cases. But the fact that the corporate enterprise is a unitary one, in the sense that the ultimate gain is derived from the entire business, does not mean that for the purpose of taxation the activities which are conducted in different jurisdictions are to be regarded as 'component parts of a single unit' so that the entire net income may be taxed in one State regardless of the extent to which it may be derived from the conduct of the enterprise in another State. • • • And the principle that was recognized in *National Leather Co.* v. *Massachusetts*, *supra*, was that a tax could lawfully be imposed upon a foreign corporation with respect to 'the proportionate part of its total net income which is attributable to the business carried on within the State.' When, as in this case, there are different taxing jurisdictions, each competent to lay a tax with

respect to what lies within, and is done within, its own borders, and the question is necessarily one of apportionment, evidence may always be received which tends to show that a State has applied a method, which, albeit fair on its face, operates so as to reach profits which are in no just sense attributable to transactions within its jurisdiction."

In the instant case the fact was clearly established by the stipulation of facts that Appellant had incurred a *loss* of $82,851 from its operations in California in 1935, whereas the statutory formula allocated to that state a net income of $93,551.50. In other words, by the mere application of a formula a loss in fact of $82,851 was converted into a taxable profit of $93,551.50. So far as California is concerned, a net income of $175,000 has been created out of nothing. Either that, or $175,000 of income has been appropriated from other states.

Appellee, as we understand it, insists that the instant case is ruled by the *Underwood Typewriter Co.* v. *Chamberlain*, 254 U. S. 113, *Bass, Ratcliff & Gretton* v. *State Tax Commissioner*, 266 U. S. 271, and *North American Cement Corporation* v. *Graves*, 299 U. S. 517, cases.[1] In view of Appellee's insistence in this regard we deem it necessary to discuss those cases at some length.

In *Underwood Typewriter Co.* v. *Chamberlain*, 254 U. S. 113 (in the State court—94 Conn. 47, 108 Atl. 154), the Underwood Typewriter Company—a Delaware corporation—was engaged in the manufacture, sale and repair of typewriters. Its only manufacturing plant was at Hartford, Connecticut. The company also sold and rented adding machines made in Connecticut by other manufacturers, rented slot machines made by it in Connecticut, and sold desks and other typewriting supplies not manufactured in

1. Appellee also insists that Appellant seeks to use a separate accounting method in part and an allocation method in part, contrary *Norfolk & Western Ry. Co.* v. *North Carolina*, 297 U. S. 682. Appellee's contention in this regard will be discussed in a later portion of this brief.

the state at all. The company's net income as reported for Federal income tax purposes was $1,336,586.13.

The Connecticut statute in terms imposed a tax upon the net income of the corporation. The statute itself was uncertain as to whether as a matter of construction it was intended as imposing a tax in the nature of an excise tax or a tax in the nature of a property tax, or a tax in the nature of a direct tax on income. Of the net income on which the company paid its Federal income taxes, the Tax Commissioner apportioned $629,658.50 to Connecticut as constituting that part of the income properly allocable to that state—based upon the statutory formula. This resulted in allocating 47 per cent of the company's entire net income to the State of Connecticut. The State court stated in its opinion that the company was contending that the tax was levied upon net income resulting from business done and sales made outside of the State of Connecticut, and that that contention erroneously assumed that the tax was an income tax as such and not a privilege tax imposed upon the privilege of carrying on a manufacturing business in the state. Accordingly the court stated that the real question was whether such a privilege tax based upon 47 per cent of the plaintiff's entire net income was a tax upon its business done, or its property located, outside of the state. In this view the statute and the resulting tax was sustained. The court then said that the argument against the constitutionality of the statutory apportionment must go to the point of showing successfully that 47 per cent of the company's net income could not reasonably be attributed to its manufacturing and warehousing and shipping operations in Connecticut. In that view the court went on to say that the burden was upon the company to show the unreasonableness of the allocation and that upon the record before the court the company had made no attempt to shoulder such a burden. The court said that as the record before it

stood it was asked to take judicial notice of the fact that 47 per cent of the net income of the company could not reasonably be attributed to the company's operations in Connecticut, and

> "to declare the statute unconstitutional upon the bare assertion that the statutory method of apportionment, as applied to the company's income, taxes property and business without the state, although 53 per cent of the plaintiff's income is exempted by the apportionment."

This Court (254 U. S. 113) said (p. 118):

> "The Underwood Typewriter Company is engaged in the business of manufacturing typewriters and kindred articles; in selling its product and also certain accessories and supplies which it purchases; and in repairing and renting such machines. Its main office is in New York City. All its manufacturing is done in Connecticut. It has branch offices in other States for the sale, lease and repair of machines and the sale of supplies; and it has one such branch office in Connecticut. All articles made by it—and some which it purchases—are stored in Connecticut until shipped direct to the branch offices, purchasers or lessees."

Then specifically as to the contention that the tax was upon business not within the state it was said (p. 120):

> "It is contended that the tax violates the Fourteenth Amendment because, directly or indirectly, it is imposed on income arising from business conducted beyond the boundaries of the State. In considering this objection we may lay on one side the question whether this is an excise tax purporting to be measured by the income accruing from business within the State or a direct tax upon that income; for the 'argument, upon analysis resolves itself into a mere question of definitions, and has no legitimate bearing upon any question raised under the Federal Constitution.' *Shaffer* v. *Carter*, 252 U. S. 37, 55. In support of its objection that business outside the State is taxed plaintiff rests solely upon the showing that of its net profits $1,293,-

643.95 was received in other States and $42,942.18 in Connecticut, while under the method of apportionment of net income required by the statute 47 per cent of its net income is attributable to operations in Connecticut. But this showing wholly fails to sustain the objection. The profits of the corporation were largely earned by a series of transactions beginning with manufacture in Connecticut and ending with sale in other States. In this it was typical of a large part of the manufacturing business conducted in the State. The legislature in attempting to put upon this business its fair share of the burden of taxation was faced with the impossibility of allocating specifically the profits earned by the processes conducted within its borders. It, therefore, adopted a method of apportionment which, for all that appears in this record, reached, and was meant to reach, only the profits earned within the State. 'The plaintiff's argument on this branch of the case,' as stated by the Supreme Court of Errors, 'carries the burden of showing that 47 per cent. of its net income is not reasonably attributable, for purposes of taxation, to the manufacture of products from the sale of which 80 per cent. of its gross earnings was derived after paying manufacturing costs.' The corporation has not even attempted to show this; and for aught that appears the percentage of net profits earned in Connecticut may have been much larger than 47 per cent. There is, consequently, nothing in this record to show that the method of apportionment adopted by the State was inherently arbitrary, or that its application to this corporation produced an unreasonable result."

In *Bass, Ratcliff & Gretton* v. *State Tax Commissioner*, 266 U. S. 271, the New York statute was involved. That statute clearly levied an excise tax upon the privilege of doing business in the State of New York. The corporation there involved was an English company engaged in brewing and selling Bass' ale. All of its brewing was done and a large part of its sales were made in England, although a portion of its product was imported into the United States

and sold through branch offices located in New York City and Chicago. In determining the amount of income allocable to the State of New York a formula was followed which was authorized by the statute (266 U. S. 279). This Court sustained the tax on the authority of the *Underwood* case, saying in that connection (p. 282):

> "So in the present case we are of opinion that, as the Company carried on the unitary business of manufacturing and selling ale, in which its profits were earned by a series of transactions beginning with the manufacture in England and ending in sales in New York and other places—the process of manufacturing resulting in no profits until it ends in sales—the State was justified in attributing to New York a just proportion of the profits earned by the Company from such unitary business. In *Wallace* v. *Hines*, 253 U. S. 66, 69, it was recognized that a State, in imposing an excise tax upon foreign corporations in respect to doing business within the State, may look to the property of such corporations beyond its borders to 'get the true value of the things within it, when they are part of an organic system of wide extent,' giving the local property a value above that which it would otherwise possess, and may therefore take into account property situated elsewhere when it 'can be seen in some plain and fairly intelligible way that it adds to the value of the property and the rights exercised in the State.' This is directly applicable to the carrying on of a unitary business of manufacture and sale partly within and partly without the State.
>
> "Nor do we find that the method of apportioning the net income on the basis of the ratio of the segregated assets located in New York and elsewhere, was inherently arbitrary or a mere effort to reach profits earned elsewhere under the guise of legitimate taxation. The principal factors entering into this allocation are, as in the *Underwood Case*, the real and tangible personal property of the corporation. We see nothing arbitrary in also including bills and accounts receivable resulting from the manufacture and sale of merchandise and services performed, or in taking average monthly

values as the measure of all the segregated assets except shares of stock. And in the present case the inclusion of a portion of the shares of stock in other corporations,—none of which were allocated to New York—resulted in the Company's favor, and reduced the income allocated to New York to less than it otherwise would have been.

"It is not shown in the present case, any more than in the *Underwood Case*, that this application of the statutory method of apportionment has produced an unreasonable result. The fact that the Company may not have had any net income upon which it was subject to payment of income tax to the Federal Government, obviously does not show that it received no net income from the business which it carried on in New York. There is no evidence in the record as to whether the Company received any net income from its New York business, or the amount of the profit and loss on that business, if any, either considered separately or in connection with the manufacturing business carried on in Great Britain."

The *Underwood* and *Bass* cases hold that a statutory method of apportionment is not *per se* void and that a statute providing for such method of apportionment is not *per se* invalid. Appellant makes no contention to the contrary. The *Rees* case, however, establishes the principle that a statutory method of apportionment, albeit fair on its face, will not be sustained where it results unreasonably and arbitrarily. In other words, a statutory method of apportionment must yield to the requisite factual showing of the unreasonable and arbitrary consequence of its application. In the *Rees* case, according to the company's showing, about 17 per cent of its net income was reasonably attributable to the State of North Carolina as against approximately 80 per cent attributable to that state under the statutory apportionment formula. In the instant case although the formula method of apportionment attributed about 8 per cent of Appellant's total income to the State of California — $93,551.50 — nevertheless the agreed facts

clearly show that Appellant had no net income whatsoever in California, but rather an actual loss of $82,851. In the instant case, therefore, the statutory formula serves to convert a loss *in fact* of $82,851 into a "net income" of $93,551.50. Or, in other words, the statutory formula creates $175,000 of income out of nothing, or, as we have said, appropriates that much income from other states.

As stated, section 10 of the Franchise Tax Act professes an intent not to subject the taxpayer to double taxation, and it would seem obvious that the application by the court below of the statutory formula of allocation has violated such intent. It is agreed that Appellant's total income for the year in question was $1,149,000, and it was to this income that the state's percentage allocation was applied. But in determining that income there was taken into consideration the $82,851 loss in California. The result is that the remaining houses produced an income of $1,231,000, and it is upon that income that the other states are entitled to impose their respective taxes. If, then, the statutory formula is to be permitted to create a taxable income in California of $93,551.50 as against the actual loss of $82,851, the result is as a matter of plain necessity that there is an addition to the company's total income of $175,000—the difference between a net loss of $82,851 and a taxable profit of $93,551.50—thereby making Appellant's income for the year $1,324,000 instead of the $1,149,000. In this view it would seem to be obvious that Appellant is subjected to a double tax on this $175,000 of income which the court below has appropriated from Appellant's business conducted elsewhere than in California, and has given to California in order to create a tax.

We point out the foregoing not for the purpose of arguing in this court a mere question of statutory construction, but to point out the fact that the statutory formula taxes income not within the jurisdiction or control of the State of California.

If anything, the instant case is a clearer case for the invalidation of the tax than the *Rees* case.

The case of *North American Cement Corporation* v. *Graves*, 299 U. S. 517, seems to be the chief reliance of Appellee and the court below. In that connection Appellee seems to consider that the *North American Cement* case overruled the *Rees* case. We fail to see any basis for that view in view of the ground upon which the judgments of the New York courts were sustained, namely, that the statute

> "is valid upon its face, and it has not been shown to have been so applied as to violate Appellant's constitutional rights." (Citing the *Bass* case.)[1]

As to the *North American Cement* case the court below said that it holds that in the case of a unitary business "separate accounting in accordance with recognized accounting practice is insufficient evidence to disprove the propriety and presumption of fairness of formula allocation" (R. p. 34).

The case, we submit, holds no such thing, and the court below seems grievously to have misunderstood the decision. As a matter of fact the case did not involve, strictly speaking, a "separate accounting" method, rather, what is sometimes termed a so-called equitable method of apportionment.

In his petition in the court below for a hearing by that court after the decision of the District Court of Appeal, Appellee included a statement of the purported facts of the *North American Cement* case which it was said had been taken from volume 2253 United States Supreme Court records on file in the San Francisco City and County Law Library. Appellee stated that the company in that

1. The fact that the *Rees* case has been recently cited—*James* v. *Dravo Contracting Co.*, 302 U. S. 134; *Department of the Treasury of the State of Indiana, et al.* v. *Wood Preserving Corporation*, ... U. S. ....., decided April 28, 1941, does not suggest in any way that this Court regards the *Rees* case to have been overruled.

case, operating two cement plants in New York, one in Maryland and a lime plant in West Virginia, "operated its four plants separately and sold their products in separate districts, kept *separate accounts* for them, and sold very little of the output of the West Virginia and Maryland plants in New York." Appellee further stated that the New York Tax Commission applied an allocation formula to the entire net income of the corporation for the years 1925, 1926, 1927, and 1929, thereby allocating large income to New York for each year; that a reputable accounting firm each year made, certified and published an audit of the company's annual operations; that the certification of accuracy related to only one of the two New York plants, but because of the manner of preparation of the audit the certification also established that the accountants believed the report fairly showed the New York income." It was further stated that the accountants found it necessary to break down the company's profits and expenses into two categories, one within New York and the other without New York, and that having found the income and expenses earned within and without New York the accountants then segregated the New York income and expenses between the New York plants. The 1927 accounts were said to be representative and were set forth in the appendix to Appellee's petition.

We assume that the same material will be set forth in Appellee's brief in this court.

Appellee further stated that the results were certified by the accounting firm as accurately showing the results of the operations of the New York plant involved, and that it could be seen that under the method followed by the accountants "it was necessary correctly to show the results of the entire New York business before an accurate picture of part of it could be obtained. Thus the certification demonstrates that the accounting firm believed the accounting fairly determined the New York income."

Appellee further stated that by such "separate accounting method" a smaller income for 1925 was allocated to New York than by the formula method, and that for 1926, 1927 and 1929 large losses instead of income were allocated to New York.

It was then said that in the face of such evidence, this court, affirming the New York courts, held that the results of the formula were controlling and upheld the assessment based thereon.

Based upon the above analysis of the case, Appellee concludes that it held first that the operations of the four separate manufacturing plants, one of them making a different product from a different material, are so interrelated as properly to be treated as unitary, and second that "separate accounting in accordance with recognized accounting practices is insufficient evidence to disprove the propriety and presumption of fairness of the formula allocation."

Appellee has woefully misread and misconceived the case. The case is reported in New York Tax Cases, 1903 to 1906, New York Tax Service Supplement published by the Commerce Clearing House, Inc. at paragraph 94-285. The facts as there reported are taken from the brief of the Attorney General of the State of New York. It appears from that statement that the corporation reported net income in varying amounts for the years in question, and for the base year 1927 a net income of $272,663.50. In each of the years the corporation's returns showed the segregated assets between New York state and elsewhere. In 1927 the resulting New York percentage based upon such segregated assets was 56.7769 per cent.[1]

Taxes were assessed by the taxing officials upon the exact basis of the corporation's returns. Thereupon the

1. Apparently nothing was said in the company's returns about any so-called "separate accounting" nor was there apparently any claim made that the various plants were operated as separable units, or that the accounts of the various plants were kept separately.

corporation asked for an "equitable adjustment" of the taxes pursuant to section 211 of the tax law as in force in 1925.[1]

Thereafter a conference was held between the corporation and the Commission, and a formal hearing was had, at which time the statements [of the accountants] were submitted, and there was some testimony that the sales in New York by the out of the state plants amounted to "practically nothing." The statements and this testimony was the only evidence submitted by the corporation.

The corporation's total production of cement during 1927 was 3,387,595 barrels, of which 1,907,425 barrels, or 56.31 per cent of the total, was produced in New York. In 1929, one of the years involved, the New York production was more than 61 per cent of the total. The volume of production in the other two years, 1924 and 1925, did not appear. Upon that showing the assessment originally made was confirmed and such was apparently the record upon which the New York courts and this court were asked to invalidate the tax.

The accountants' statements set out, as we have stated, in Appellee's said petition in the court below, showed that there were two plants in New York—the so-called Howe's Cave plant and the Catskill plant—these two plants apparently being known as the Albany district. The Maryland plant and the West Virginia plant [the lime plant] were known as the Hagerstown district. It is clear from the statements, however, that there was no separate accounting by the New York plants, and for all that appears in the statements the various plants were not separated and segregated, nor were any of their accounts maintained separately. The accountants' statement included

1. Section 211 was held invalid in *People ex rel. Ducas Co., Inc.* v. *State Tax Commission*, 260 N. Y. 525, 184 N. E. 77, on the ground that the statute was so vague as to not constitute a workable rule for the guidance of the Tax Commission. From the report of the *North American Cement* case above mentioned it appears that the Attorney General conceded the invalidity of the statute in his brief.

an income account for the Catskill plant, which starts with net sales, cost of sales, and miscellaneous income, giving a gross income of $202,440.88. There was then allocated to the Catskill plant a percentage of the *total expenses* of the entire business of the company—34.44 per cent—which was the ratio of the cement shipped from the Catskill plant to the total cement shipped from all plants. The resulting expense thus allocated to the Catskill plant amounted to $258,501.07, leaving a net operating profit of $56,060.19. Against this operating profit was then charged interest and financial expenses amounting to $131,144.11, which again was based upon a percentage allocation. However, the accountants' statements further combined the so-called gross profit of the Howe's Cave plant and the Catskill plant, and then charged against such profit a percentage of the total expenses of the business of all kinds, based again upon the ratio of cement shipped from the two New York plants to the total cement shipped from all points. This resulted in a New York percentage of 56.31 per cent as against a percentage of 43.69 allocated to the out of the state plants. Also there was an allocation of the total interest and financial expense to the New York plants based upon the same type of percentage as was used in connection with the accountants' income statement with reference to the Catskill plant.

The result of all this was that the New York plants in 1927 showed a loss as against a total income from the company from all plants of the $272,663.50.[1]

While these statements undoubtedly appear in the record in that case before this court, we trust that Appellee will include them in his brief herein.

It must be obvious, therefore, that the situation in the

1. This situation seems very much like that involved in the *Norfolk and Western* case, 297 U. S. 682 where the gross income of the North Carolina mileage was determined by an allocation formula upon a percentage basis, whereas the expenses were claimed to be the actual expenses of such mileage. Hence the company used a percentage formula to determine revenue, but not expenses.

North American Cement case was nothing like that in the case at bar. Here, under the stipulation of facts, it appears that the San Francisco house was operated substantially as an independent unit and its accounts in fact were kept by the company upon a separate basis. The case at bar is not a case where, merely for the purpose of computing a tax, accountants put together an income statement for the plant within the taxing state. Whatever effect such accountants' statements or reports might have in appealing to the discretion of the taxing officials, they obviously have no probative value as evidence when the question of the validity of the tax becomes the subject matter of review by the courts. In the case at bar the accounts of the San Francisco house are a matter of evidence. They are not a matter merely of opinion on the part of the accountants. And such accounts were kept with respect to the San Francisco house in the due course of Appellant's business, and in the due course of the operations of the San Francisco house. They were not put together for the purposes merely of determining a tax or in order to try the present lawsuit.

It is inconceivable how this Court or the New York courts themselves could have arrived at any conclusion other than that the case was controlled by the *Underwood Typewriter* and *Bass* cases and that the evidentiary or factual situation did not meet the requirements laid down in the *Rees* case.

The principle followed in the *Rees* case was not at that time a particularly novel principle, inasmuch as it had theretofore been recognized and applied in numerous cases in this Court. In *Fargo* v. *Hart*, 193 U. S. 490, where the apportionment formula was held invalid, this Court said:

> "And when that property is part of a system and has its actual uses only in connection with other parts of the system, that fact may be considered by the State in taxing, even though the other parts of the system are outside of the state * * *.

"• • • It is obvious, however, that this notion of organic unity may be made a means of unlawfully taxing the privilege, or property outside the State, under the name of enhanced value or good will, if it is not closely confined to its true meaning."

In *Illinois Central Rd.* v. *Greene*, 244 U. S. 555, the tax was on an allocated proportion of the total capital stock—based upon the proportionate mileage within the State. The taxpayer introduced evidence showing that upon the particular facts of the case the statutory allocation produced an unfair result. This Court upheld that contention and held the statute invalid, saying:

"• • • although the fact that property is part of a system and has its actual uses only in connection with other parts of the system may be considered by the State in taxing that portion of the system which is within its borders, yet the notion of organic unity must not be made the means of unlawfully taxing property without the State."

In *Union Tank Line* v. *Wright*, 249 U. S. 275, where a formula allocation was also held invalid because of the factual situation, this Court said:

"How to appraise them [the properties sought to be taxed] fairly when the tangibles constitute part of a going concern operating in many states often presents grave difficulties; and absolute accuracy is generally impossible. We have accordingly sustained methods of appraisement producing results approximately correct—for example, the mileage basis in case of a telegraph company, and the average amount of property habitually brought in and carried out by a car company. But if the plan pursued is arbitrary and the consequent valuation grossly excessive, it must be condemned because of conflict with the Commerce Clause or the Fourteenth Amendment or both • • •.

"• • • Taxes must follow realities; not mere deductions from inadequate or irrelevant data."

Wallace v. *Hines*, 253 U. S. 66, involved an excise tax upon the doing of business in the State—based upon the

total value of property proportioned in accordance with the main line mileage in the state and elsewhere. In invalidating the tax measured in this fashion because of the factual situation, this Court said:

> "The only reason for allowing a state to look beyond its borders when it taxes the property of foreign corporations is that it may get the true value of the things within it, when they are part of an organic system of wide extent, that gives them a value above what they otherwise would possess. The purpose is not to expose the heel of the system to a mortal dart—not, in other words, to open to taxation what is not within the state. Therefore no propery of such an interstate road situated elsewhere can be taken into account unless it can be seen in some plain and fairly intelligible way that it adds to the value of the road and the rights exercised in the state."

In *Southern Ry.* v. *Kentucky*, 274 U. S. 76, involving a franchise tax based upon an allocation of income dependent upon the proportionate mileage within the state, this Court said:

> "The mileage used as an integral part of a railroad system may have elements of value that it otherwise would not possess, and the state property may have regard to the whole in order to ascertain the value of the part that is within its borders. • • • But if the method pursued in valuing property within the state is arbitrary and the resulting valuation is grossly excessive the tax must be condemned as in contravention of the due process clause of the 14th Amendment."

In that case the evidence indicated that the Kentucky lines were operated at a loss, whereas the system as a whole showed a net profit. Apparently the court considered the factual showing in that regard to be adequate.

In *Nashville C. and St. L. Ry.* v. *Browning*, 310 U. S. 362, this Court said (p. 365):

> "The problem to be solved is what portion of an interstate organism may appropriately be attributed to

each of the various states in which it functions. Basic to the accommodation of these conflicting state and national interests is realization that by its very nature the problem is incapable of precise and arithmetical solution. In tapping these common sources of revenue a state cannot, we have held, use a fiscal formula, whatever may be its appearance of certitude, to project the taxing power of the state plainly beyond its borders."

Citing:

Wallace v. *Hines*, 253 U. S. 66.

Wallace v. *Hines*, is referred to by the court below in connection with its quotation from the opinion of the *Bass* case (R. p. 31), but without any recognition of the fact that in that case the formula was stricken down—even though the decision recognized that, absent the requisite factual showing, a formula allocation not *per se* unreasonable or arbitrary might be sustained.

The *Nashville* case last above cited does not impair any of the earlier decisions of this Court above cited. In that case the court was dealing with a property tax and the question was as to the proper valuation of the company's lines in Tenessee. The Tennessee lines were valued upon a basis proportionate to the line's Tennessee mileage. The company's objection to the valuation of the Tennessee property as such was that it failed to produce a commensurate income. Obviously the question of income is not of itself controlling on the question of an *ad valorem* tax on the property itself—even though it is properly one factor for the consideration of the assessment officers. However, as to the earlier cases this Court said:

"Wherever the states' taxing authorities have been held to have intruded upon the protected domain of interstate commerce in their use of a mileage formula, the special circumstances of the particular situation, in the view which this Court took of them, precluded a

defensible utilization of the mileage basis. * * * No such circumstances are here presented."

The opinion and reasoning of the state court in the *Rees* case closely resembles that of the court below in the instant case,—even though, from the standpoint of the question of a "unitary" business, the instant case with its separate branch houses is far removed from the manufacturing business in the *Rees* case. When we consider that the underlying reason for applying an allocation formula to total net income to arrive at the income properly attributable to the taxing state is that the one contributes to the whole of the income, we see how little application such a formula allocation has in the case of a business like that of Appellant, where each of its branch houses is operated substantially as an independent business and the results in any one house have little, if any, bearing upon the operations at another house. And when we also see that in the instant case a loss has resulted in California even though the San Francisco house benefited from Appellant's aggregate purchasing power by being charged for its merchandise only the actual cost thereof plus transportation to San Francisco, we see how unreasonable and arbitrary it is to apply an allocation formula where the result is to create income where none exists in fact.

It appears from paragraph 7 of the stipulation (R. p. 10) that the allocation percentage is based upon Appellant's real and tangible property within and without the state, wages, salaries, etc., within and without the state, and gross sales within and without the state. It is difficult, if not impossible, to conceive how, in view of the manner in which Appellant's several houses are operated, the amount of merchandise or other property, including real estate, owned by the company in other states, or the amount of its payroll, etc., in other states, or even its gross sales in other states, have, or could have, any direct bearing upon

the results of the operation of the San Francisco house. That property, those wages and salaries, and those sales could be more or less in amount in dollars in other states without materially affecting the results of the San Francisco house whatsoever. And we say this although the stipulation in paragraph 7 further provides that no question is raised respecting the use of the formula in question "if by reason of the facts stipulated herein a formula for application to California of a portion of the company's income from all sources is proper."

In other words, the stipulated facts, we respectively submit, clearly demonstrates the inapplicability of the statutory formula where the California income can be otherwise reasonably and accurately determined.

II.

THE FACT THAT A BUSINESS IS "UNITARY" IS NOT CONTROLLING IN DETERMINING THE LEGALITY OF A STATUTORY FORMULA METHOD OF APPORTIONMENT.

The court below says in its opinion (R. p. 28):

> "If there is any evidence to sustain a finding that the operations of appellant in California during the year 1935 contributed to the net income derived from its entire operations in the United States, then the entire business of appellant is so clearly unitary as to *require* a fair system of apportionment by the formula method in order to prevent overtaxation to the corporation or undertaxation by the state." (Italics ours.)

The *Underwood* case is cited in support of that statement. The opinion further states (R. p. 27):

> "The answer to this question [the legality of the formula method of allocation] depends entirely upon the nature of the business conducted within and without the state by appellant, a foreign corporation. It is only if its business within this state is truly sep-

arate and distinct from its business without this state, so that segregation of income may be made clearly and accurately, that the separate accounting method may properly be used."

In the first place, no decision of this Court supports any such view as that expressed by the court below in the last above excerpt from its opinion. And even if it were supported by any decision of this Court, the Court's action in the instant case conclusively demonstrates that the language in question is, and can be, given no practical force or effect. Appellant's business operations in the State of California are far more susceptible of segregation and separation from its operations in other states than in the case of a mere manufacturing business like that involved in the *Underwood* and *Bass* cases, and in the *Rees* case. And even in the case of a rail carrier the rule of the *Rees* case applies if the factual situation warrants,[1] although the lines of an interstate carrier are less susceptible of segregation and separation than most any kind of business conceived of. Yet in those types of businesses the fact that the business is unitary is not of itself a controlling factor. As was said in the Rees case:

"Undoubtedly, the enterprise of a corporation which manufactures and sells its manufactured product is ordinarily a unitary business, and all the factors in that enterprise are essential to the realization of profits. The difficulty of making an exact apportionment is apparent and hence, when the State has adopted a method not intrinsically arbitrary, it will be sustained until proof is offered of an unreasonable and arbitrary application in particular cases. But the fact that the corporate enterprise is a unitary one, in the sense that the ultimate gain is derived from the entire business, does not mean that for the purpose of taxation the activities which are conducted in different jurisdictions are to be regarded as 'component parts of a single unit' so that the entire net income

1. *Norfolk & Western Ry. Co. v. Maxwell*, 297 U. S. 682.

may be taxed in one State regardless of the extent to which it may be derived from the conduct of the enterprise in another State. * * * When, as in this case, there are different taxing jurisdictions, each competent to lay a tax with respect to what lies within, and is done within, its own borders, and the question is necessarily one of apportionment, evidence may always be received which tends to show that a State has applied a method, which, albeit fair on its face, operates so as to reach profits which are in no just sense attributable to transactions within its jurisdiction."

III.

THE FACT THAT THE TAX IS AN EXCISE TAX IS IMMATERIAL.

It may be contended by Appellee that a statutory formula for allocating income to the taxing state will be sustained where the tax is an *excise* or *franchise* tax, even though it might not be sustained where the tax is an income tax. This contention necessarily goes to the extent of saying that the decision in the *Rees* case does not apply in the case of an excise or franchise tax as distinguished from an income tax. This distinction has no support in the decisions of this Court.

As heretofore pointed out, the statute involved in the *Underwood* case was not clear as to what type of tax it imposed. The state contended that the tax was in the nature of an excise tax. Others contended that the tax was a property tax, and still others contended that the tax was an income tax. The Connecticut court held that the tax was an excise tax levied upon the privilege of doing business in the state. In this Court it was said (254 U. S. 113, at p. 120):

"In considering this objection we may lay on one side the question whether this is an excise tax purporting to be measured by the income accruing from business within the state or a direct tax upon that

income; for the 'argument upon analysis resolves itself into a mere question of definitions and has no legitimate bearing upon any question raised under the Federal Constitution.''

The New York statute involved in the *Bass* and North American Cement cases was an excise tax. Neither case was decided upon any distinction between an excise or franchise tax and an income tax. The North Carolina statute involved in the *Rees* case was in terms a tax upon net income, but was said by the North Carolina court to be substantially identical with the Connecticut statute construed in the *Underwood* case (103 S. E. at p. 853). We take it, therefore, that the North Carolina statute must also be regarded as an excise tax, with the result that the *Rees* case did involve an excise or franchise tax and not an income tax as such.

The California statute here involved has been considered by the California court to lay an excise or franchise tax. *Matson Navigation Co.* v. *State Board*, 3 Cal. (2d) 1, 43 Pac. (2d) 805, affirmed, *Matson Navigation Co.* v. *State Board*, 297 U. S. 441; *Pacific Co.* v. *Johnson*, 212 Cal. 148, 298 Pac. 489, affirmed *Pacific Co.* v. *Johnson*, 285 U. S. 480. In all of the cases dealt with by this Court the ultimate decision has turned upon the factual situation and not upon any claimed distinction between an excise or franchise tax and an income tax.

In connection with the *Matson* case above mentioned, the court below states in its opinion (R. p. 36) that the formula method of allocating or apportioning income in the case of a unitary business was there approved. We do not so read that case. The *Matson* case involved domestic corporations, and the question was as to whether the statutory formula should be applied to a base which included receipts from interstate and foreign commerce. The companies contended, first, that the statute should not be interpreted as including such receipts in the tax base, and, second, that if

they were to be so included the statute was void. The California court held that the tax base should include receipts from interstate and foreign commerce and its decision in that regard was affirmed by this court. There is no such question in the instant case. The San Francisco house included in its gross receipts sales made throughout its own territory, including receipts from all interstate sales. No claim has ever been made by Appellant that the receipts of the San Francisco house derived from sales in interstate commerce should be excluded. In the *Matson* case this Court said (297 U. S., at pp. 444, 5) that the question in the *Rees* case "was as to the apportionment of income to the taxing state," and that the controversy in the then case [the *Matson* case] concerned the amount "to be paid for the privilege of using in California corporate franchises granted by that state" to the companies, and that "no question of apportionment is here involved."

IV.

APPELLANT'S BUSINESS IS NOT UNITARY.

The decision of the court below is premised entirely upon the proposition that Appellant's business is unitary. The court, therefore, concludes, as we have said, that a statutory formula allocation is not only required by the statute itself but is necessarily valid from the constitutional standpoint—wholly irrespective of the factual situation involved. We contended in the court below, and we here contend, that in fact Appellant's business is not unitary. The term "unitary" is not a term having any particular legal concept. The term is used to convey an idea, which was stated by this Court in the *Rees* case, that "the ultimate gain is derived from the entire business." We think there should be added to this statement some further qualification which imports some continuity of operation, as in the case of a

manufacturing business where the goods are manufactured in one state and then transported to other states for sale. In the instant case Appellant does not manufacture, and the actual merchandise sold at the various houses is manufactured at various locations throughout the United States. It is true that all merchandise is centrally purchased at Appellant's headquarters at Chicago, but this simply means that the buying offices are located at Chicago where the buyers carry on such buying operations. The merchandise itself is not stored at headquarters but is shipped to the various houses directly from the various factories and mills. Appellant's central buying division is not at all comparable to a manufacturing plant.

Appellant's only business is that of selling to retailers the merchandise which it purchases. The sales and other attendant activities are severally conducted at Appellant's seven houses, each of which serves its own trade territory, maintains its own stock of goods, and handles its own solicitation, sales and credit arrangements. Goods purchased from manufacturers are shipped directly to these various houses, from which they are, in turn, shipped to the company's customers. The greater part of all operating expenses are directly and exclusively incurred at the respective houses. These direct expenses, together with the cost of goods purchased for resale, amounted to approximately 98 per cent of the total expense of the San Francisco house in 1935.[1]

It is stipulated (R. p. 9; Stipulation of Facts, par. 4) that except for the common expenses allocated to the various houses, each house is operated independently of each other house. These common expenses consist of "executive salaries, certain accounting expenses, the cost of operating a central buying division, and a central adver-

1. Sales of the San Francisco house in 1935 amounted to $5,200,000. (R. p. 18.) The net loss was $82,851 (R. p. 17), indicating a total operating cost of $5,088,851. Of this only $100,091 represented allocation of common expenses. (R. p. 16.) This $100,091 is less than 2 per cent of the total expense of the San Francisco house.

tising division" (Stipulation, Par. 4; R. p. 9). Paragraph 3 of the stipulation states that in the case of the central buying division no charges are made against any house for the benefit of the company or any other house by reason of such centralized purchasing, but the actual cost of operating the centralized buying division is allocated to the houses (R. pp. 8-9).

Paragraph 4 of the stipulation explicitly states that "no question exists as to the accuracy of the amounts of such expense or to the method of allocation employed, which is in accordance with recognized accounting practices." (R. p. 9.)

In the case of a manufacturing business, obviously without sales offices and without any sale of goods the factory is of no value and produces no income. In the instant case the San Francisco house could be closed at any time without any especial effect upon the remainder of the Appellant's business carried on at its other six houses. In other words, there is no continuity of any kind as between Appellant's business as a whole and the San Francisco house. According to paragraph 9 of the stipulation (R. pp. 10-11) an amount of purchases equal to those made for the account of the San Francisco house results in no more favorable prices than could be obtained in respect to purchases in an amount equal to the purchases which would be made by the company for its other houses if the San Francisco house were not in existence, and a reduction in the volume of purchases in an amount equal to the purchases made for the San Francisco house would result in no less favorable prices being obtainable in respect of the purchases which would be made for the remaining houses of the company. In other words, the existence of the San Francisco house neither adds to nor detracts from Appellant's aggregate purchasing power, and none of Appellant's other houses is in any way dependent upon the San Francisco house for its continued existence. Obviously

in the case of a manufacturing business the sales offices are dependent upon the factory for merchandise, and in turn the factory is dependent upon the sales offices for the moving of the merchandise. Appellant's various houses are about as separate and distinct operating units as is possible to have. The fact that the purchasing operations are carried on at headquarters for the benefit of all of Appellant's branch houses is entirely immaterial.

That confusion exists in the mind of the court below is demonstrated, we believe, by what is said with reference to the so-called buying profit. It is said (R. p. 29):

> "It is our opinion that the sales made in each of the seven states in which appellant does business must be proportionately credited with the profits resulting from the purchasing power which such sales in the aggregate produce."

It would seem obvious that the benefit to Appellant as a whole from its aggregate purchasing power cannot exceed the difference between the prices actually paid for merchandise and the prices which would have been paid had purchases been made separately for each house alone. It would seem equally obvious that to effect proportionate distribution of that saving each house must be credited with that fraction of the total savings which the purchases made bear to the total. When, therefore, as here, only the actual cost of the goods purchased for the account of the San Francisco house is charged to that house it has received in fact its full proportionate measure of the purchasing saving of the company as a whole. And this can be done in no other way. Only if it should appear that each of Appellant's houses—and the San Francisco house in particular—is charged with merchandise at a price higher than the actual cost thereof, could it be said that that house is not proportionately credited with the profits resulting from the purchasing power of the company as a whole. Therefore when it absolutely appears, as it does in the instant case by the stipulation of the parties, that each

of Appellant's houses—and the San Francisco house in particular—is charged for its merchandise only with the actual cost thereof, then the court's statement above mentioned is clearly shown to be without merit or substance. If, as the court below says, the San Francisco house purchases may not be ignored, then to a corresponding extent the purchasing advantages of Appellant as a whole cannot be attributed to the San Francisco house beyond its fair contribution thereof. As to this the court below says (R. p. 28):

> "By its large scale purchasing activity, appellant concededly is able to buy at lower prices than would otherwise be possible, thus realizing a purchasing saving. But it is able to buy in large quantities only because it is able to sell in large quantities, so that it is apparent that the purchasing saving is made possible only because of the sales."

We take it that this statement of the court is but a restatement of the last sentence of paragraph 8 of the stipulation (R. p. 10) that—

> "By reason of the volume of purchases made by the Company more favorable prices are obtained than would be obtained in respect of purchases for the account of any individual house operated by the Company."

But we still inquire, what of it? The fact still remains, as the court below itself recognizes, that the parties have agreed that the purchases made for the account of the San Francisco house have no effect whatsoever upon the company's aggregate purchasing power. (Stip. Par. 9, R. p. 10.) The court seems to dismiss paragraph 9 of the stipulation with the bare statement (R. p. 28) that Appellant had urged that the "San Francisco store is the one which does not affect purchase price differentials." But in this connection it is not merely what Appellant urges, but rather it is what the stipulation states, and it is not competent for the court below to go in back of the

stipulation and find the fact other than what the stipulation states the fact to be.

There is nothing inconsistent so far as we can see in agreeing that the company's total volume of purchases at all houses enable it to buy at lower prices than if each house purchases separately, and at the same time to agree that the addition or subtraction of purchases equal to those made for the account of the San Francisco house would not affect at all Appellant's aggregate buying power. That is what the stipulation has provided. So again we see that when the San Francisco house is charged with merchandise at the actual cost thereof it has received the greatest possible benefit of Appellant's aggregate purchasing power and has in fact received its full proportionate share of the profit resulting from the company's aggregate purchasing power.

Appellee's point seems to us to be fully met by the California District Court of Appeal in its opinion herein. (R. p. 22.) The court said:

> "They [the State] contend that the disposal of some $5,000,000 worth of merchandise during the time mentioned increased the purchasing power of Appellant and thus permitted it to buy for its other houses through volume purchases at a price lower than it otherwise would have secured. It appears, however, that the parties have stipulated otherwise. We quote from the agreed facts: 'A reduction in the volume of purchases made by the San Francisco house would result in no less favorable prices being obtainable in respect of the purchases which would be made for the remaining houses of the Company.' "[1]

1. The above quotation is taken from the record as it is. (p. 22.) There was a slight modification by the Court of Appeals of its said opinion when the State, in its petition for rehearing in that court, called attention to the fact that there was an inaccuracy in the court's quotation from the agreed facts. The actual wording in the stipulation was that "a reduction in the volume of purchases *in an amount equal to the purchases* made for the San Francisco house." The words in italics were the words omitted by the court in its statement. The court of appeals, however, for purposes of accuracy, directed that its opinion be modified accordingly, saying in that connection: "No point is made by respondent

In its opinion denying the rehearing the court of appeals said:

> "It is stated that the court failed to note certain stipulated facts covering the effect of volume purchases. Such facts were not omitted. They also appear in the statement given earlier in the opinion. They may state a *general* law of economics but as the parties had definitely stipulated with reference to the operations of the San Francisco branch the latter facts must control as applying to this specific instance."

And by way of conclusion in its original opinion the court of appeals said (p. 24):

> "We therefore conclude that the stipulated facts show that the company actually incurred a loss in California; that its California earnings could have been accurately ascertained without the necessity of recourse to any arbitrary formula, and that the use of such formula results in the imposition of a tax not earned in California and therefore not subject to its taxing power."

There are a number of cases in the state courts which may well be considered.

In *J. G. McCrory Co.* v. *Commissioner*, 280 Mass. 273, 182 N. E. 481, taxpayer was a corporation which, with some sixteen other corporations, was owned by the McCrory Stores Corporation—the parent company. McCrory stores are retail stores operating as part of a chain, although each individual store happens to be separately incorporated. Generally speaking such stores are of the same general type as the large integrated variety retail chains like Woolworth & Company, or dry goods stores like the Penny and Grant Stores, and like the large retail catalog houses like Montgomery Ward and Sears, so far at least as concerns their retail outlets.

[the State] arising out of the omission of the words used. Furthermore, such words appear in the statement of facts given in the opinion before such quotation was used.

The opinion as thus modified appears in the report of the case in 102 Pac. (2d) 776 at page 779.

In all of these cases all of the stores are under a common management and control, and all merchandise is bought through a central buying agency.

In the McCrory case the Commissioner assessed the tax based upon a percentage of the consolidated income of all of the stores, although according to the evidence the store located in Massachusetts operated at a loss. In that case the merchandise was charged to the retail stores at cost plus a service charge or commission of 10 per cent. Only to this extent was any effort made to attribute any part of the buying profit to the central buying agency. Likewise, as in the case of Appellant, each individual store was charged with a certain proportionate part of certain overhead expenses, etc. The company insisted that its income was to be determined for tax purposes in accordance with the actual figures pertaining to the store, and this claim was sustained by the Massachusetts court. While in that case the court made some mention of the fact of the separateness of the corporate entities, the basic reason for sustaining the company's position was that the income of the Massachusetts store could be accurately and reasonably determined through its own accounting figures, and that to assign to Massachusetts any of the income received by the remaining McCrory stores was to attribute and tax income in Massachusetts which did not exist in that state. The court said in its opinion that cases like the *Underwood Typewriter* case were essentially unlike the case with which it was then dealing, and that its conclusion was in harmony with the *Rees* case.

The opinion of the court below mentions a number of other state court decisions. To one of them—*Standard Oil Co.* v. *Wisconsin Tax Commission*, 197 Wis. 630, 223 N. W. 85—the opinion devotes considerable space (R. p. 34). With all due respect to the California court, we do not understand the distinction which it asserts with respect to the Wisconsin case. In the Standard Oil case plaintiff did

business both within and without Wisconsin. It owned extensive refineries outside of the state. It maintained numerous tanks and filling stations within the state. About 54 per cent of the company's products were sold within the State of Wisconsin and 46 per cent outside the state. The assessment made by the Commission was arrived at by determining a fraction which resulted from averaging the percentage of the tangible property within the state to the total tangible property everywhere, the percentage of manufacturing cost within Wisconsin as compared with the total manufacturing costs, and the percentage of sales within Wisconsin as compared to the total sales. The resulting fraction was about 4 per cent. This percentage was applied to the company's total income, the resulting taxes amounting to some $156,000. The company claimed that its Wisconsin income should be determined in accordance with the actual operation of the Wisconsin business. In that connection it appeared that the Wisconsin business was charged with the products sold at market price rather than mere cost. The result of this was that part of the so-called manufacturing income was attributed to states other than Wisconsin. The company's method produced an income attributable to Wisconsin of $1,273,413, and a tax of about $89,000. The court sustained the company's position, saying:

> "In the enactment of the statute relating to the allocation of income of persons doing business within and without the state, the declared legislative purpose is to make a reasonable and equitable distribution of the taxpayer's income to the end that that part of the income justly assessable in the state of Wisconsin may be ascertained. The statute does not enjoin upon the commission the use of that method which will produce the largest amount of taxable income but rather that method which will most justly apportion the income properly taxable in Wisconsin. *Here it appears conclusively that it is possible to ascertain the income derived from business transactions in Wisconsin by*

the application of proper accounting methods. It appears without dispute that the tax commission has had full access to all the records of the plaintiff company and has been given every opportunity to confirm the correctness of the statements submitted to it by the plaintiff." (Italics ours.)

The court distinguished the *Underwood Typewriter* case, stating that there was nothing in that case inconsistent with its holding in the case before it. In that connection the court said that there was no reason why the profits derived from the sale operations in Wisconsin should not be ascertained (223 N. W. at p. 88.)

"as they would be if the sales operations were conducted by a separate corporate entity. In either case the profits were earned at the same time and place."

The court below criticizes the Wisconsin case because it did not attribute to Wisconsin the whole of the manufacturing profit—*i. e.*, because the Wisconsin business was charged with the goods sold at *market price* rather than cost. But even if the criticism were just the instant case would not be affected inasmuch as here Appellant's San Francisco house is charged only with the actual cost of the merchandise and thereby it receives its proportionate share of the so-called buying profit. Even if in the Wisconsin case the Oil Company's Wisconsin business were charged only with the *cost* of the product sold by it, the case would still stand as authority for invalidating a tax based upon a percentage of the company's total income where the income attributable to the particular taxing state—there Wisconsin—could be reasonably and accurately determined as a separate operating unit.

The court below also cites *International Elevator Co.* v. *Thoresen*, 58 N. Dak. 776, 228 N. W. 192, as holding that "the unitary character of the buying and selling business" was recognized. (R. p. 35.) In that case the company maintained elevators in North Dakota and Montana and

sold grain in various states, principally at Minneapolis and Duluth. The company insisted on determining its income based upon receipts from sales made in North Dakota alone. The state applied a statutory formula to determine the income, and apparently no question was made as to the use of the formula if the income was not to be limited solely to North Dakota sales. The court overruled the company's position, thereby attributing to North Dakota an income not limited merely to sales of grain in North Dakota. We have no particular criticism to make of that decision as the case was presented to the court for decision. The question there was no different than had the Rees Company in the *Rees* case claimed that its manufacturing profit in North Carolina was limited solely to sales of leather goods made in the State of North Carolina.

We do not see that the North Dakota case is any support for the decision of the court below—certainly not from the standpoint of the Federal question involved.

Montgomery Ward & Co. v. *State Tax Commission*, 151 Kas. 159, 98 Pac. (2d) 143, is sometimes taken as sustaining a separate accounting method as against the allocation method. There was no issue, however, in that regard, between the company and the taxing state, the issue there, as we read the case, being as to whether or not the Kansas stores should be charged for merchandise upon a basis greater than the actual cost. In its actual operations in Kansas the Ward stores were charged with merchandise only at the cost thereof—none of the so-called buying profit being attributed to the central buying headquarters as such. In its tax returns, however, the company insisted that the merchandise should be charged to the Kansas stores upon a basis greater than cost in order that a reasonable part of the buying profit should be attributed to localities other than Kansas. The company's position in this regard was sustained by the Kansas court.

Were Appellant here contending that all or part of the so-called "buying profit" should be attributed to Illinois, where Appellant's principal office is located and its buying operations are carried on, in other words, that the San Francisco house, in determining its profit or loss, should be charged with the merchandise sold by it at some amount greater than the actual cost thereof—Appellant could properly urge the Kansas decision as supporting its position. Likewise the *Standard Oil* case would also support that position. In the *Standard Oil* case, however, the court not only dealt with the specific question last mentioned, but went further and required the Wisconsin income to be determined upon its own footing where such income could be reasonably and accurately determined by the actual figures pertaining to the Wisconsin business, and refused to sanction a statutory formula method of allocation.

The court below, as to the *Standard Oil* case, seems to confuse those two questions and goes off, in its criticism of the *Standard Oil* case, upon the sole question relative to the manufacturing profit of the company. The court below seems to ignore entirely the other basic question considered by the Wisconsin court as to the inapplicability of a formula method of allocation where the income within the taxing jurisdiction is otherwise reasonably and accurately susceptible of determination.

As we read the State's argument in the Wisconsin case, and we believe the Wisconsin court so understood the argument, it was that Standard's business was unitary and that therefore the only accurate way of determining the income from the Wisconsin business was on the basis of an allocation formula. See 223 N. W. at p. 87. It was in that connection that the Wisconsin court said that:

> "• • • it appears conclusively that it is possible to ascertain the income derived from business transactions in Wisconsin by the application of proper accounting methods."

In *Standard Oil Co.* v. *Thoresen*, C. C. A. 8, 29 Fed. (2d) 708, the Tax Commissioner of North Dakota applied an allocation formula. After holding that

> "the legislature of the state, in enacting the statute above quoted, did not intend to impose a tax on the property of the plaintiff company or its income from the doing of business other than the character of business done in the State of North Dakota, that is, selling oil in that state."[1]

the court said (p. 711):

> "There can be no question whatever but that any statute of a state which attempts to tax property located in another state is void and beyond the power of the state. * * *
>
> "This position, we believe, is conceded by the state; but the contention here made by the state is this: The business of plaintiff may and should, for the purpose of taxation, be regarded as a unit in the production, transportation, refining and marketing of oil. From a reading and consideration of the many cases on the subject we are not of that opinion. In some cases the unit theory of taxation, attempted to be here applied is all right and has been upheld by the Supreme Court of our country in such cases as *Underwood Typewriter Co.* v. *Chamberlain, Treasurer of State of Conn.*, 254 U. S. 113, * * * and in *Adams Express Co.* v. *Ohio*, 165 U. S. 194 * * *."
>
> * * * * *
>
> "The plaintiff in this case is engaged in the production of crude oil in those states wherein crude oil is found. There is no crude oil discovered in the state of North Dakota. The plaintiff has also engaged in the manufacture and refining of crude oils in many states, but has not done so in the state of North Dakota. It has engaged in marketing refined oil alone in that state. On its properties within the state of North Dakota employed in the business of marketing oil, and on the income arising from the doing of that business

1. The California statute here involved professes a like intent. See section 10, *supra*, p. 2.

within the state of North Dakota it may be there taxed by the state and the tax must be paid. On its business of producing and refining oil it should be taxed only by the state in which this production is found or refining done. In the manufacture or refining of crude oil in different states it must be taxed and pay its taxes within said states; others, not engaged in the production or refining of oils, engaged in the marketing of refined oils in the state of North Dakota. It is conceded to be a very easy matter for the state to determine the market value of refined oils within its borders at any time and place, and on this, having ascertained the selling price, to determine the tax necessary to be paid."

The application of the statutory formula was held improper.

The same reasoning and principle applies to the instant case. Appellant's San Francisco house is conducted just the same as any of its competitors' businesses in that state, including competitors doing business wholly within the state of California. Whether Appellant makes a profit in some one or more of the other states, or incurs a loss in those states has no reasonable relevancy to its operations in California. And we believe without question that had Appellant suffered large losses in states other than California, and had had a profit in that state, Appellee would have been the first to disclaim the statutory formula of allocation. Whether in a given year or under given circumstances the taxing state gains or loses by the application of a statutory formula is a purely fortuitous circumstance. Here again the remarks of the Wisconsin court are pertinent when it said (223 N. W. 88):

"The statute does not enjoin upon the Commission the use of that method which will produce the largest amount of taxable income, but rather that method which will most justly apportion the income properly taxable in Wisconsin."

A similar decision appears in *Fisher, State Treasurer of North Dakota* v. *Standard Oil Co.*, C. C. A. 8, 12 Fed. (2d) 444, wherein it was said:

> "The theories of allocation can have no place in the inquiry if net income within the state stands on its own footing, unmixed with outside business." Citing *Wallace* v. *Hines*, 253 U. S. 66.

See, also:

Standard Oil Co. v. *Howe*, 257 Fed. 481.

The court below also cites *Great Atlantic & Pacific Tea Co.* v. *Grosjean*, 301 U. S. 412. That case is quite inapposite here. There this court sustained a chain store tax measured by the total number of stores in the chain, either within or without the State of Louisiana. We do not see that the remarks of the court below as to that case (R. p. 36) have any special significance.

On the question of the significance of a "unitary" business the remarks of the Utah Supreme Court are in point. In *Utah-Idaho Sugar Co.* v. *Salt Lake County*, 60 Utah 491, 210 Pac. 106, 114, the court said:

> "The doctrine never has been applied, however, nor can it justly and equitably be applied, to manufacturing or other similar plants or industries which may be under common ownership, but used or operated in different states. Taking plaintiff's numerous plants as an illustration, in the very nature of things they are, precisely as the court found, operated and used entirely independent of one another. The failure or even the destruction of one factory or plant has no effect upon any other one. Neither is the property used in connection with those plants, or any part of it, used at any one time in one state and at another time shifted or moved to another state. But the plants and the property used in connection therewith are just as stationary and immovable as though each one was owned by a different individual or corporation. All there is, therefore, is a unity of ownership, which, as a matter of course, cannot control either local or general taxation."

In *State* v. *Lion Oil Refining Co.*, 117 Ark. 209, 284 S. W. 33, 36, the court said:

> "• • • it is manifest that there can be no organic relation between its plants situated in different states, and there can be no connected use of these plants within the rule laid down • • •. Each one could be separately operated and might be shut down without any impairment of the operating power of its other plants in the other two states."

While the views of the Arkansas court and perhaps the Utah court may be too restricted in considering that the unit rule of taxation should be applied only to carriers and the like and not to manufacturing or oil companies, nevertheless their view as to the separableness of the corporate operations is in point.

The term "unitary" is defined in *Maxwell* v. *Kent-Coffey Mfg. Co.*, 168 S. E. 397, 399, as follows:

> "It is admitted in the brief for appellee that its business is unitary. That term is simply descriptive, and primarily means that the concern to which it is applied is carrying on one kind of business—a business, the component parts of which are too closely connected and necessary to each other to justify division or separate consideration, as independent units. By contrast, a dual or multiform business must show units of a substantial separateness and completeness, such as might be maintained as an independent business (however convenient and profitable it may be to operate them co-jointly), and capable of producing a profit in and of themselves."

The above opinion is that of the North Carolina court whose decision had been reversed by this Court in the *Rees* case. And certainly the North Carolina court in the above *Kent-Coffey* case had no misconceptions as to what its own views were as expressed in the *Rees* case, and what the views of this Court were as expressed in the same case upon appeal.

It is conceded, of course, that Appellant's seven branch houses have unity of ownership. Nevertheless the fact is, as the stipulation states, that Appellant's seven houses are

separate and distinct business units. They have no "organic unity" or "unity of use," but on the contrary have a "substantial separateness and completeness such as might be maintained as an independent business."

There is no magic in the term "separate accounting." This Court, in determining the constitutional question, is not concerned with mere descriptive terms or adjectives. The point of the *Rees* case and the principal which is recognized in all of the other cases relied upon by Appellee, is that if the income within the taxing state can be determined with reasonable accuracy then there is no constitutional room for the application of a statutory formula when the income determined upon the basis of such formula is far in excess of the income in fact.

Where the business operations of a taxpayer doing business in several states is of a separable and individual character sufficiently so that the results of its operation can be reasonably and accurately determined by itself, then the tax can constitutionally be layed only with respect to the actual income within the state. The Georgia court has summed up the proposition very concisely in a recent decision. *Mexican Petroleum Corporation of Georgia* v. *Head*, 13 S. E. (2d) 887. After construing the Georgia statute to tax all corporations only upon that portion of their business reasonably attributable to the trade or business within the state, the court considered the propriety of an allocation formula. The court said:

> "Where the business done within the State is distinctly divisible from the business done in other jurisdictions by the same corporation, ordinarily the total income from all operations can not be used as a basis of computation. See 75 L. Ed. 900, annotation. * * * The theories of allocation can have no place in the inquiry if the net income within the State stands on its own footing unmixed with outside business."

Among other cases referred to by the court was the *Rees* case.

V.

APPELLANT HAS NOT ACCEPTED AN ALLOCATION FORMULA IN PART AND ATTACKED IT IN PART.

Appellee contends that this Court has held that the formula method of allocation cannot be accepted in part and attacked in part. Reference is made to *Norfolk & Western Ry. Co.* v. *Maxwell*, 297 U. S. 682. Appellee's contention in this respect differs somewhat from the contention of the California Supreme Court also based upon the *Norfolk & Western* case. The court below said (R. 37):

> "As appellant has failed to show a variance from normal in either the California sales, property or payroll, or in either expenses or revenue, it is our conclusion that appellant has not upheld its burden of proof, for in order to overthrow a formula the taxpayer must introduce such evidence and the evidence must go to each element of the formula equation."

What Appellee means is that there were certain expenses in the way of general overhead and the like which necessarily had to be divided up or allocated among the various branches or divisions of Appellant's business, which expenses were allocated upon a percentage basis. If Appellee's contention in this regard were correct it would never be possible to determine a separate income in any one state in the case of a corporation doing business in various states under a single management or control inasmuch as there must always be in such cases some sort of an allocation of the common expense among the various states.

In view of Appellee's contention and of the court's statement, we take time to state what we understand the holding in the *Norfolk & Western* case to have been. In that case taxable net income of interstate railways was based upon the proportion of mileage within the state to the railroad's total mileage. Under the apportionment formula the "gross revenues" were first determined by the mileage ratio and

the gross expenses, also determined by the mileage ratio, were then deducted. The railroad in question accepted the gross revenues determined upon such mileage ratio but claimed that the gross expenses determined by such ratio were substantially less than the expenses of the North Carolina mileage. As to whether the expenses of the North Carolina mileage were more or less than those as determined by the statutory formula this Court said (297 U. S. at page 686) that there was evidence in the record giving support to the company's position and that up to that point the company took upon itself the burden of making out a case for the rejection of the formula. This Court then said, however (p. 686):

> "There, however, it stopped, declining to go further. From the testimony of its witnesses we learn that actual expenses were greater in North Carolina than the average expenses apportioned to that state on the basis of the ratio between state and system mileage. We learn nothing from the witnesses as to the ratio between revenues, average and actual. For all that appears in the case developed by the Railway actual gross revenues in North Carolina may have been so far in excess of average gross revenues computed under the statute as to neutralize the discrepancy between actual and average costs of operation. If such a counterbalance exists, appellant has not been injured through the application of the formula."

It then appeared that the state itself had offered evidence that through the application of the formula the gross revenues of the North Carolina mileage were underestimated to a greater extent than the operating expenses. On this branch of the case the company's witnesses claimed that there was no method of allocating revenues with any greater approach to certainty than by means of the mileage ratio. As to that testimony this Court said that either for that reason or some other the witnesses had not made an attempt to ascertain receipts, no matter how approxi-

mately, by any other method as assuredly they would have tried to do if the statutory formula had been abolished altogether. The trial court found that from the evidence the actual gross operating revenues if determined otherwise than by the formula "would be increased by a much greater proportion than the operating expenses in North Carolina are increased over the operating expenses determined by the use of the statutory formula." That finding was approved by the Carolina Supreme Court. This Court then went on to say that the taxpayer attacking the formula could not attack the prorating on the expense side and offer no evidence as to the revenue side, and that the evidence

> "to be effective must be directed to each of them alike, for only thus can the assumed relation between them be proved to be unreal. This taxpayer disclaims the duty and even the endeavor to respond to such a test. It varies the numerator of the fraction while accepting the denominator."

Had Appellant in this case applied an allocation formula to its total expenses at all houses, and at the same time insisted upon using as the gross revenue of the San Francisco house only the actual receipts from sales made at that house,[1] or conversely if it had applied an allocation formula to its total sales or gross receipts and then used the actual expenses of the San Francisco house in determining its California income, a question would have been presented quite different from that presented by the present record. In the instant case both gross revenue and expense have been determined by the actualities of the operations of the San Francisco house, excepting only to the extent of the necessity of allocating to the San Francisco house as additional expense a reasonable proportion of the common expenses. While perhaps such common expenses could have been allocated upon some basis other than that actually employed, nevertheless there is no issue between the parties in that regard in view of the stipulation:

"That the accuracy and propriety of the basis of

allocation of such common expenses for the year 1935 are admitted." (Stipulation of Facts, par. 4; R. p. 9.)

It is further to be noted that a simple arithmetical computation discloses that in view of the total sales of the San Francisco house amounting to $5,206,000 (R. p. 10) and the operating loss of $82,851, the total operating costs must have amounted to $5,288,851, of which the allocated common expense amounted only to $100,091—less than 2 per cent of the total operating expense of the San Francisco house..

It was also stipulated that of the allocated common expense amounting to $100,091, 75 per cent would have been incurred even had the San Francisco house not been operated. (R. p. 9.) Were this 75 per cent, or $75,000, eliminated from the San Francisco account entirely Appellant would still have incurred a loss at that house. Only by eliminating all of the allocated common expense would a "net income" result—and then only in the amount of $18,000, the difference between the $82,851 of loss as shown and the amount of the allocated common expense of $100,091. However, as we see it, to eliminate from the San Francisco accounts any part of the overhead or other common expense would be not only to distort the income of that house, but also to distort the income of the other houses inasmuch as the other houses would have to absorb the whole of such expense.

Under the facts of this case the *Norfolk & Western* case does not support Appellee's position, or the decision of the court below. Certainly what this Court had to say in that case about a partial use of a statutory apportionment method in determining the income to be taxed by the taxing state has no relevancy to the instant case.

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1. As the company apparently tried to do in *North American Cement Company* v. *Graves*, 299 U. S. 517.

VI.

The Court Below Was in Error in Deciding This Case by Indulging in Inferences and Presumptions Contrary to the Provisions of Paragraph 12 of the Stipulation of Facts Upon Which This Case Was Tried.

We have assigned error in the above regard. (R. pp. 43; 48.)

We refer, in this connection, to such statements in the opinion of the court below as the following:

> "If the omission of the California sales would have no effect on the purchasing power, the omission of sales in an equal amount wherever made would likewise have no effect on the company's ability to purchase at a saving. Thus, by proceeding in turn from state to state, it could be shown that *none of the sales in any of the states* should be credited with the income resulting from the purchasing of goods in large quantities." (Italics ours.) (R. p. 29.)

> "The former [the central advertising division] enables appellant to spread its advertising cost over more stores and units and to secure its advertising at a lower cost per unit, thereby making possible advertising opportunities unavailable to a single store; as to the latter (central accounting and management department), the volume of business resulting from operation of the company's several stores permits better as well as more costly services of accounting and management to be available to each store, whereas if each were separately operated, services of such quality in all probability would be too expensive to be practicable." (R. p. 29.)

> "In the case at bar appellant has not furnished any explanation of why its California business differs so from the average that the formula produced an erroneous result." (R. p. 37.)

> "*As appellant has failed to show a variance from normal in either the California sales, property or pay-*

roll, or in either expenses or revenue, it is our conclusion that appellant has not upheld its burden of proof. * * *" (R. p. 37.)

All of these are matters wholly outside of the Stipulation of Facts, and amount to mere speculation and conjecture on the part of the court in direct violation of paragraph 12 of the Stipulation of Facts.

In the Petition for Rehearing (R. pp. 38-40) we called the Court's attention to these conjectural matters. As to the first statement above quoted, perhaps the court merely meant that the elimination of sales at any house equal to those at the San Francisco house would not affect the company's aggregate buying power. But even this would be problematical. Suppose that some other of appellant's several houses, say the Chicago house, had total sales of $15,000,000. Then suppose further that $5,000,000 of these sales were eliminated. What the result would be if carried to a normal and logical conclusion is purely conjectural. If such an event were to take place, the Chicago house might not be able even to operate, thereby eliminating—through cause and effect—the whole of the $15,000,000. So far as anything appearing in the stipulation in this case is concerned such elimination would most certainly affect the company's aggregate buying power. The statement of the California Supreme Court therefore in this light must be considered purely as an abstraction and meaningless.

As a matter of fact, however, we are inclined to doubt if the California court intended such a limited meaning to its statement. The following sentence is that by proceeding in turn from state to state it could be shown that "none of the sales" in any of the states should be credited with the income resulting from the purchasing of goods in large quantities. We would understand the court to mean by this statement that the elimination of the whole of the sales at some one or another of the other houses would have no effect upon the company's aggregate buying power.

There is nothing in this record to support such a violent assumption or conjecture. The effect of the elimination or addition of amounts equal to the purchases made for the account of the San Francisco house was the subject matter of paragraph 9 of the Stipulation of Facts. (R. pp. 10-11.) There was no equivalent stipulation as to the effect of the elimination or addition of amounts equal to the purchases made for the account of any of Appellant's other houses. Whatever such effect might be is not the proper subject matter of conjecture in deciding this case.

As to the second statement above quoted, there is nothing whatsoever in the stipulation as to what constitutes the so-called "central advertising division" mentioned in paragraph 4 of the stipulation and the expense of which constituted a part of the common expense. (R. p. 9.) In Appellant's Petition for Rehearing in the court below, to which we have referred, Appellant offered to show by evidence that the

> "so-called advertising of the company consists wholly in the preparation of catalogs and their distribution to retailers with whom the company does, or seeks to do, business, and that no advertising advantages other than certain economies of preparation exist by reason of the presence of the seven houses."

Likewise there is no such term used any where in the stipulation as "central accounting and management division"—although we can only assume that the court has in mind the statement in paragraph 4 of the stipulation that there are included in the allocated common expenses "executive salaries" and "certain accounting expenses." The court's statement, therefore, as to the economies of what it terms the "costly services of accounting and management" are wholly speculative and conjectural.

As to the last statement above quoted, we have already taken occasion to say that the court below, as does Appellee, seems in this indirect fashion to challenge the cor-

rectness of the *stipulated* facts as to the California loss. As has just been stated, the reason for there being a loss in California is of no relevancy as against the controlling factor that a loss did in fact result as shown by the stipulation. In Appellant's petition for rehearing in the court below Appellant as to this point offered to produce evidence as to why the San Francisco house operated at a loss. (R. p. 42.) We point out, however, both as to this point and as to the nature of the so-called "central advertising division" Appellant has the right to produce the evidence itself—if such evidence is to be deemed material—and should not be required to present it to the court in any such summary manner.

Appellee seems to say that the ultimate conclusion from the facts stipulated as to the results of the Appellant's operations in California would itself be barred if our objection were good, and that therefore Appellant has stipulated itself out of court. The answer to this argument would seem rather obvious. In the first place, Appellee is incorrect in saying that in such a case the California court would be guilty of a mere error which would not give this Court jurisdiction. When a reviewing court decides a case by indulging in inferences and presumptions and in speculation and conjecture contrary to the agreement and stipulation of the parties upon which the case was tried, which in terms precludes any decision from being made based upon any such inferences and presumptions or speculations or conjectures (Stipulation of Facts, par. 12) and resolves all of such inferences, presumptions, speculations and conjectures adversely to Appellant instead of remanding the case for the taking of further evidence to supply the deficiencies as said paragraph 12 of the Stipulation of Facts contemplated, appellant has in effect been denied an opportunity to be heard upon matters which, at least to the mind of the California court, were material facts. Such a situation is clearly within the principles announced in

Saunders v. *Shaw*, 244 U. S. 317. Appellant certainly had no reason to anticipate that the California Supreme Court would find it necessary to, and would actually depart, from the stipulation of the parties in deciding this case adversely to appellant—certainly when the California Appellate Court in its opinion and judgment had held the assessment void. (R. p. 16.) And this action having been done by the California Supreme Court in its opinion in this case, Appellant's first opportunity of objecting to such procedure was through its petition for rehearing herein. Where there is such a denial of an opportunity to be heard Appellant's constitutional rights have been infringed and the objection can be taken for the first time on the petition for hehearing. *Saunders* v. *Shaw, supra; Ex rel. Missouri Insurance Co.* v. *Gehner*, 281 U. S. 313; *Brinkerhoff-Faris Co.* v. *Hill*, 281 U. S. 673. See also *American Surety Co.* v. *Baldwin*, 287 U. S. 156; *Great Northern Ry. Co.* v. *Sunburst Oil & Refining Co.*, 287 U. S. 358.

The further answer is that Appellant's challenge was not directed to the Court's making the ultimate factual conclusion from the facts which were stipulated, but it was directed to such inferences and presumptions as the court indulged in when it questioned the stipulated facts and questioned whether or not a loss ever occurred and speculated as to the advertising division, and executive salaries and accounting expenses. Finally we point out that even if Appellee were correct and the court below was precluded from making the ultimate conclusion from the stipulated facts that a loss resulted in California, paragraph 12 of the Stipulation would still operate and the case would have to be returned to the trial court for the taking of further proofs as the Stipulation in terms provides.

Appellee claims that the purpose of the Stipulation

> "was to overcome the presumption of official regularity and not to shift the burden of proof from plaintiff to defendant or to remove the burden of proof from both parties."

We are not clear as to just what appellee means by such statement. Nevertheless nothing in the Stipulation suggests that paragraph 12 had any such limited or restricted meaning or effect. The obvious purpose of a stipulation of facts is to obviate the time and expense of taking evidence as to factual matters which are agreed upon by the parties. It was supposed by both parties that the facts stipulated were sufficient to permit of a decision of this case upon the merits. The purpose of the stipulation was to preclude any decision adverse to either Appellant or Appellee in the possible event that the facts as stipulated were insufficient to permit of a decision being made. This can only be the meaning of paragraph 12 in providing that if

> "this stipulation fails to establish any fact necessary to a decision, the case shall be reopened for the taking of further proofs with respect thereof." (Stipulation of Facts, paragraph 12; R. p. 11.)

The stipulation, and paragraph 12 thereof, do not bar the Court from declining to decide a question of importance like that involved in the instant case if the facts presented are adequate for that purpose—or even if the Court thinks that the facts presented are inadequate. In fact paragraph 12 contemplated the possibility that the Court might take that view of the matter. At the same time with such contingency in mind the stipulation was intended to safegard the rights of both Appellant and Appellee and to insure their right to present evidence as to any matters which were, or which in the opinion of the California courts were, insufficiently or inadequately covered by the stipulation. It was never intended to permit the Court—if the stipulated facts were inadequate to permit of a decision on the merits—to indulge in speculation and conjecture as to factual matters outside of the stipulation and decide all of them adversely to Appellant. Had the court below indulged in such speculation and conjecture as to factual matters adversely to Appellee we are quite sure he would have promptly and vigorously objected—as he

properly should do. And the situation resulting from this course of action on the part of the court below is made more acute because of the fact, as we view it, that the matters thus made the subject matter of speculation and conjecture are wholly irrelevant and immaterial so far as the controlling issues in this case are concerned. Appellant insists that the stipulated facts are fully adequate without additions thereto by the Court in the way of inference or presumption to decide the Federal question presented, and that the facts as stipulated require a decision in Appellant's favor if the case is to be decided consistently with the principles announced in the *Rees* case.

And if in the face of paragraph 12 of the Stipulation the stipulated facts themselves are deemed insufficient to permit of a decision of this case, and if thereupon the case is to be decided adverse to Appellant contrary to such stipulation, Appellant certainly has been denied the requisite opportunity to be heard as to the validity of the tax in question.

Conclusion.

We do not understand that this Court regards the *Rees* case as overruled or shaken in any way by any of its later decisions. As we understand it, in the *North American Cement* case the State accepted the *Rees* case without question, and argued the case upon the ground that it came within the principles of the *Underwood* and *Bass* cases rather than the *Rees* case. The *per curiam* decision indicates such to be the case. Under the *Rees* case, the judgment below, we insist, must be reversed.

Respectfully submitted,

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APPENDIX.

AN ACT TO CARRY INTO EFFECT THE PROVISIONS OF SECTIONS 14 AND 16 OF ARTICLE XIII OF THE CONSTITUTION OF THE STATE OF CALIFORNIA RELATING TO BANK AND CORPORATION TAXES, APPROVED MARCH 1, 1929, STATS. 1929, P. 19.

"4. *Financial corporation to pay tax.* • • •

(3) *Corporations other than financial doing business in this State to pay tax. Minimum tax.* With the exception of financial corporations, every corporation doing business within the limits of this State and not expressly exempted from taxation of the provisions of the Constitution of this State or by this act, shall annually pay to the State, for the privilege of exercising its corporate franchises within this State, a tax according to or measured by its net income, to be computed, in the manner hereinafter provided, at the rate of four per centum upon the basis of its net income for the next preceding fiscal or calendar year. In any event, each such corporation shall pay annually to the State, for the said privilege, a minimum tax of twenty-five dollars.

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6. *The term 'gross income'*, as herein used, includes gains, profits and income derived, from the business, of whatever kind and in whatever form paid; gains, profits or income from dealings in real or personal property; • • •

8. *Deductions allowed.* In computing 'net income' the following deductions shall be allowed:

(a) *Expenses.* • • •
(b) *Interest.* • • •
(c) *Taxes or licenses.* • • •
(d) *Uncompensated losses.* • • •
(e) *Bad debts.* • • •
(f) *Depreciation.* • • •
(g) *Depletion.* • • •

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10. *Computation of tax on intrastate business.* If the entire business of the bank or corporation is done within this State, the tax shall be according to or measured by its entire

net income; and if the entire business of such bank or corporation is not done within this State, the tax shall be according to or measured by that portion thereof which is derived from business done within this State. The portion of net income derived from business done within this State, shall be determined by an allocation upon the basis of sales, purchases, expenses of manufacturer, pay roll, value and situs of tangible property, or by reference to these or other factors, or by such other method of allocation as is fairly calculated to assign to the State the portion of net income reasonably attributable to the business done within this State and to avoid subjecting the taxpayer to double taxation.

If the commissioner reallocates net income upon his examination of any return, he shall, upon the written request of the taxpayer, disclose to him the basis upon which his reallocation has been made.

12. *Computation of net income.* The net income shall be computed upon the basis of the taxpayer's annual accounting period, fiscal year or calendar year as the case may be, in accordance with the method of accounting regularly employed in keeping the books of such taxpayer; but if no such method of accounting has been so employed, or if the method employed does not clearly reflect the income, the computation shall be made in accordance with such method as in the opinion of said commissioner does clearly reflect the income. If the taxpayer's annual accounting period is other than a fiscal year, or if the taxpayer has no annual accounting period or does not keep books, the net income shall be computed on the basis of the calendar year.

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13. *Returns.* (a) Every bank and corporation shall, within two months and fifteen days after the close of its income year, transmit to the commissioner a return in a form prescribed by him, specifying, for the income year, all such facts as he may by rule, or otherwise, require in order to carry out the provisions of this act.

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15. *Form of returns.* Every return required by this act to be filed with said commissioner shall be verified by an executive officer of the bank or corporation. Blank forms of return shall be furnished by said commissioner on appli-

cation, but failure to secure such a form shall not release any taxpayer from the obligation of making a return hereunder.

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18. *Penalties for failing to file, or filing false returns.* Any bank or corporation failing or refusing to furnish any return hereby required to be made or failing or refusing to furnish a supplemental return or other data required by the commissioner, or rendering a false or fraudulent return, shall be guilty of a misdemeanor and subject to a fine of not exceeding five thousand dollars ($5,00) for each such offense.

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24. *Interest on unpaid taxes.* (a) Interest upon the amount determined as a deficiency under the provisions of section 25 of this act shall be assessed at the same time as the deficiency, shall be paid upon notice and demand from the commissioner, and shall be collected as a part of the tax, at the rate of six per centum per annum from the date prescribed for the payment of the tax (or, if the tax is paid in installments, from the date prescribed for the payment of the first installment) to the date the deficiency is assessed.

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25. *Examination of returns. Notice of additional tax.* As soon as practicable after the return is filed, the Commissioner shall examine it and shall determine the correct amount of the tax. If the commissioner determines that the tax disclosed by the original return is less than the tax disclosed by his examination he shall mail notice to the taxpayer at its post-office address (which must appear on its return) of the additional tax proposed to be assessed against it. Such notice shall set forth the details of the proposed additional assessment and of computing said tax.

Protest. Within sixty days after the mailing of said notice the taxpayer may file with the commissioner a written protest against the levy of the proposed additional tax, as computed by the commissioner, specifying therein the grounds upon which the protest is based: The protest must be under oath."